No. 84-165-CFX
Status: GRANTED

Title: W. George Gould, Petitioner
v.
Max A. Ruefenacht, et al.

Docketed:
July 27, 1984

Court: United States Court of Appeals
for the Third Circuit

Counsel for petitioner: Epstein,Robert C., Kelly,Robert J.

Counsel for respondent: Pearlman,Peter S., Kelly,Robert J.

Entry	Date	Note	Proceedings and Orders
1	Jul 27 1984	G	Petition for writ of certiorari filed.
2	Aug 29 1984		DISTRIBUTED. September 24, 1984
3	Sep 19 1984	F	Response requested.
4	Oct 17 1984		Brief of respondent Max A. Ruefenacht in opposition filed.
5	Oct 17 1984		REDISTRIBUTED. November 2, 1984
7	Nov 5 1984		REDISTRIBUTED. November 9, 1984
8	Nov 13 1984		Petition GRANTED. The case is set for oral argument in tandem with No. 83-1961, Landreth Timber Company v. Landreth.
			**********
9	Dec 23 1984		Brief of petitioner W. George Gould filed.
10	Dec 28 1984		Joint appendix filed.
11	Dec 28 1984		Brief of respondent Christopher J. O'Halloran filed.
12	Jan 11 1985		Record filed.
13	Jan 11 1985	D	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
14	Jan 21 1985		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument DENIED. Justice Powell OUT.
16	Jan 22 1985		Record filed.
17	Jan 22 1985		Record filed.
18	Jan 23 1985	G	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
19	Jan 28 1985		Brief of respondent Max A. Ruefenacht filed.
20	Jan 29 1985		Brief amicus curiae of SEC filed.
21	Feb 5 1985		SET FOR ARGUMENT. Tuesday, March 26, 1985. (3rd case).
22	Feb 11 1985		CIRCULATED.
23	Feb 19 1985		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED. Justice Powell OUT.
24	Mar 26 1985		ARGUED.

84-165

No. _____

IN THE

Supreme Court of the United States

OCTOBER TERM 1984

W. GEORGE GOULD,

Petitioner,

vs.

MAX A. RUEFENACHT, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

ROBERT C. EPSTEIN
Attorney for Petitioner
W. GEORGE GOULD
HANNOCH, WEISMAN, STERN, BESSER, BERKOWITZ & KINNEY, P.A.,
744 Broad Street,
Newark, New Jersey 07102
(201) 621-8800

Appellate Printing Co., Inc., So. Plainfield, New Jersey (201) 753-0200

QUESTION PRESENTED

Is the purchaser of 50% of the stock of a closely-held corporation, who obtains absolute veto power over all major corporate decisions, intends to share all top level business decisions, and actively participates in the company's affairs, entitled to federal securities law protection simply because the transaction was structured as a stock purchase?

TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES

IN THE

Supreme Court of the United States

OCTOBER TERM 1984

NO. _____

W. GEORGE GOULD,

Petitioner,

vs.

MAX A. RUEFENACHT, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioner respectfully prays that a writ of certiorari issue to review the order and opinion of the United States Court of Appeals for the Third Circuit entered in this proceeding on June 11, 1984.

OPINIONS BELOW

The opinion of the Court of Appeals, entered June 11, 1984, is not yet officially reported; it is unofficially reported at [Current Binder] Fed. Sec. L. Rep. (CCH) ¶91,514, at 98,592 (3d Cir. June 11, 1984). A copy of that opinion is annexed as Appendix A. The unreported opinion and related orders of the United States District Court for the District of New Jersey are annexed as Appendix B.

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was entered on June 11, 1984. Jurisdiction to review that judgment by writ of certiorari exists pursuant to 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The statutory provisions involved are those sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 that define the term "security." The definition contained in the Securities Act of 1933, 15 U.S.C. 77b(1), is as follows:

> When used in this subchapter, *unless the context otherwise requires*—
>
> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. 77b(1) (1982) (emphasis added).

The definition of "security" contained in the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(l0), is, for present purposes, essentially identical. In each instance, the definition is preceded by the phrase "unless the context otherwise requires." The Securities Act of 1933 and the Securities Exchange Act of 1934 will hereafter be referred to collectively as the "securities laws."

Other statutory provisions involved herein are sections 12 and 17 of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934, including Securities and Exchange Commission Rule 10b-5 promulgated thereunder. These provisions are reproduced at Appendices C through F.

STATEMENT OF THE CASE

A. Circumstances of the Transaction

In June, 1980 plaintiff-respondent Max A. Ruefenacht ("Ruefenacht") purchased 2500 newly-issued shares of the common stock of Continental Import and Export, Inc. ("Continental"), an importer and distributer of wines and spirits. As a result of the purchase, Ruefenacht owned 50% of the company's outstanding shares.

The agreed-upon purchase price was $250,000, a sum which reflected a "discount" to Ruefenacht in return for his agreement to actively participate in Continental's business. In addition, in connection with the stock purchase Ruefenacht acquired multifaceted control over the company's affairs, and in fact actively participated therein, to wit: (1) he acquired the right to veto all major company decisions, both structural and operational, including stock issuance, liquidation, obtaining new product lines and borrowing funds; (2) he was to become chairman of the board of directors; (3) he was extensively involved in numerous regular meetings with suppliers, and solicited contracts to import beverages on behalf of the firm; (4) he actively participated in the company's sales and marketing efforts, in connection with which he applied for and received a state liquor license (or solicitor's permit), representing therein that he would sell alcoholic beverages to wholesalers and receive in return a salary and compensation for expenses; (5) he became a signatory for Continental's checks, and to do so denominated himself as the company's vice-president and treasurer; (6) he substantially influenced or directed the hiring of key personnel; and (7) he issued directions to Continental's counsel regarding securing wine label approvals. Ruefenacht paid $120,000 of the

total $250,000 purchase price for Continental's stock, and shortly thereafter abruptly withdrew from the company.

B. The Proceedings Below

Ruefenacht then commenced this action, alleging that his purchase of Continental stock was induced by fraudulent and negligent misrepresentations contained in certain financial documents prepared by Christopher O'Halloran (the company's accountant), and made orally by defendants Joachim Birkle (Continental's president, who owned or controlled the remaining 50% of Continental's stock), and petitioner W. George Gould (Continental's corporate counsel). Violations are alleged of sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. 77 1(2), 77q(a) (1982); section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78 j(b) (1982); and Rule 10(b)(5), 17 C.F.R. 240.10(b)(5) (1983). Also alleged are pendent state claims for fraud and breach of fiduciary duties. The complaint seeks rescission and restitution of the amount paid.

Defendant-petitioner Gould moved for summary judgment dismissing the complaint on the ground that limited discovery showed Ruefenacht to have acquired such significant control over Continental's business, and to have participated in the company's affairs to such a degree, that his stock purchase was not an idle investment with profits to come solely or primarily from the efforts of others. Therefore, Ruefenacht could not claim protection under the federal securities laws, pursuant to the authority of *S.E.C. v. W.J.Howey Co.*, 328 U.S. 293 (1946) (hereinafter "*Howey*"); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (hereinater "*Forman*"); and *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (hereinafter "*Weaver*").

The trial court held an evidentiary hearing[1] on the issue of the extent of control over Continental acquired by Ruefenacht in connection with the stock purchase. A number of specific factual findings (summarized under section A above) were made, providing the basis for the ultimate factual conclusions that Ruefenacht *was* "an active investor who intended to participate significantly in the management of the business," and *not* "a passive investor who relied on others to manage the business." As a result of Ruefenacht's control of and participation in Continental's affairs, the trial court held that "the profits of the enterprise would not be derived 'solely' or substantially from the efforts of others," and, therefore, under the authority of *Howey*, *Forman* and *Weaver*, dismissed all federal securities law claims. Additionally, the court in its discretion dismissed all pendent state law causes of action.

On Ruefenacht's appeal, the Third Circuit held that no economic analysis of the transaction should have been made, and that the securities laws apply to the transaction *a fortiori* because stock with "traditional" attributes was involved. Accordingly, the judgment dismissing Ruefenacht's complaint was reversed and the matter remanded.

Gould filed a motion to stay the mandate, pursuant to FED. R. APP. P. 41(b). By order dated July 6, 1984, issuance of the mandate was stayed until August 1, 1984.

---

1. The matter was referred to the magistrate who, after receiving testimonial and documentary evidence, rendered a report and recommendations.

REASONS FOR GRANTING THE WRIT

I. Granting This Petition Will Permit The Court To Delimit The Definition Of "Security" Under Federal Law, In Conjunction With *Seagrave Corp. v. Vista Resources, Inc.*

By granting certiorari in *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227 (2d Cir. 1982), *modified*, 710 F.2d 95 (1983), *cert. granted*, 52 U.S.L.W. 3185 (1984) (hereinafter "*Seagrave*"), this Court acknowledged the need to resolve the split in Circuit Court authority regarding the important issue of when a transfer of stock is not a transaction in "securities" within the meaning of the Securities Act of 1933 and Securities Exchange Act of 1934.[2] The issue in *Seagrave* is whether

---

2. The issue has been considered by nine courts of appeal, which are divided five to four. The Second, Fourth, Fifth and Eighth Circuits, and now the Third Circuit, reject application of the "economic reality test" applied in *Howey*, *Forman* and *Weaver*, where stock having "traditional" attributes is transferred. *See* App. A; *Daily v. Morgan*, 701 F.2d 496, 497-504 (5th Cir. 1983); *Cole v. PPG Indus., Inc.*, 680 F.2d 549, 555-56 (8th Cir. 1982); *Golden v. Garafolo*, 678 F.2d 1139, 1140-47 (2d Cir. 1982); *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). These courts hold that where "traditional" stock is involved in a transaction, the securities laws apply *a fortiori*, whether or not the protective purposes of those laws are implicated.

The Seventh, Ninth, Tenth and Eleventh Circuits hold that the economic realities of *each* transaction, including those involving a transfer of "traditional" stock, must be examined to determine whether application of the securities laws is consistent with the intended ambit and supporting policies of the statutes. *Landreth Timber Co. v. Landreth*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,705, at 97,827 (9th Cir. March 7, 1984), *petition for cert. filed*, 52 U.S.L.W. 3908 (U.S. May 31, 1984) (No 83-1961); *Christy v. Cambron*, 710 F.2d 669, 672 (10th Cir. 1983); *Sutter v. Groen*, 687 F.2d 197, 199-204 (7th Cir. 1982); *King v. Winkler*, 673 F.2d 342,344-46 (11th Cir. 1982).

the federal securities laws apply to a transfer of 100% of the "traditional" stock of a closely-held corporation. The matter thus is representative of a number of cases upholding or rejecting application of the securities laws in the context of a transfer of *total* corporate ownership, and hence *complete* corporate control. *See, e.g.*, (upholding application of the securities laws to a 100% stock transfer): *Occidental Life Ins. Co. v. Pat Ryan Assocs., Inc.*, 496 F.2d 1255, 1261-63 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); *Spencer Cos., Inc. v. Armonk Indus., Inc.*, 489 F.2d 704, 707 (1st Cir. 1973); *Alberto-Culver Co. v. Scherk*, 484 F.2d 611, 615 (7th Cir. 1973), *rev'd on other grounds sub nom, Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974); *Walling v. Beverly Enters.*, 476 F.2d 393, 395 (9th Cir. 1973). *See contra* (rejecting application of the securities laws to a 100% stock transfer): *Chandler v. Kew, Inc.*, 691 F.2d 443, 443-44 (10th Cir. 1977); *Frederiksen v. Poloway*, 637 F.2d 1147, 1150-54 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981); *Somogyi v. Butler*, 518 F. Supp. 970, 981-87 (D.N.J. 1981); *Anchor-Darling Indus., Inc. v. Suozzo*, 510 F. Supp. 659, 662-66 (E.D. Pa. 1981).

The instant case adds two important factual dimensions not present in *Seagrave*. Should this Court conclude that the economic realty test is the applicable standard, analysis of these additional factors will permit a definitive delineation of the manner of application of that test, so as to ameliorate the uncertainties and resultant tide of litigation which persist in this area.

Ruefenacht's Purchase of 50% of Continental's Stock

First, this case involves a 50% stock transfer (as opposed to the 100% transfer in *Seagrave*), which the trial court found vested in Ruefenacht joint control (with

one other shareholder) of the company such that he was able to veto all major corporate decisions.

This factor is important because decisions on *both sides* of the debate as to when stock is not a "security" for purposes of federal law regard a transfer of 50% stock ownership as a critical theoretical dividing line in evaluating whether, or in what manner, a transfer of corporate control affects securities law coverage. For example, the Seventh Circuit in *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982), applying the economic reality test to a stock transfer, established 50% stock ownership as the point beyond which one presumptively becomes an "entrepreneur" disqualified from securities law coverage, as opposed to an "investor" entitled to federal law protection. *Id.* at 203. Other courts have been greatly influenced by this approach—as noted by the Third Circuit herein, "[t]he Ninth, Tenth and Eleventh Circuits have followed the Seventh Circuit's lead." App. A at 5a.

Conversely, the Third Circuit in the present matter found great conceptual difficulty applying the economic reality test to a 50% stock purchase situation, citing such difficulty as one basis for rejecting that test in its entirety as applied to traditional stock:

> The case now before us illustrates just how far the extension of *Howey* from investment contract to note to stock may be taken. Ruefenacht is the purchaser of 50 percent of the stock of Continental. Had he purchased only 49 percent, Ruefenacht would presumably have lacked corporate control, rendering the instrument purchased (at least presumptively) a security. Had he purchased 51 percent, in contrast, the instrument would presumptively not have been a security. Both presumptions, of course—at least under the Seventh Circuit ap-

> proach, *see Sutter*, 687 F.2d at 203—would have been subject to rebuttal. Because Ruefenacht purchased exactly 50 percent, a more sophisticated analysis would presumably be required—although just what that analysis should be is less than obvious.

App. A at 15a.

The Third Circuit's view—that uncertainty of application of the economic reality analysis (as exemplified by the difficult 50% transfer situation) shows the test to be inherently flawed—is shared by other courts. *See, e.g., Golden v. Garafolo, supra; Daily v. Morgan, supra.*

Granting certiorari in the present case will allow the Court to address fundamental conceptual issues regarding the importance *vel non* of a transfer of corporate control in resolving questions of securities law coverage, both in the context of a transfer of total corporate control (as in *Seagrave*) and in the context of a transfer of control which is less than total, but still undeniably significant.[3]

Expansion of the issue to encompass a situation of less than a complete transfer of control is necessary to provide needed guidance in this important field. Any holding in *Seagrave* involving application of the economic reality test necessarily will be restricted to situations involving a 100% stock transfer, and thus will leave unresolved application of the economic analysis to a wide range of circumstances involving a transfer of less than total control. Such a result will largely fail to ameliorate the business uncertainties and flood of litigation regarding the scope of federal securities law coverage which, presumably, the grant of certiorari in *Seagrave* sought to address. In order to provide needed practical guidelines concerning the manner and extent to which a transfer of corporate control disqualifies a transaction from securities law coverage, it is necessary to address the present 50% transfer situation which, while more analytically challenging, provides the conceptual framework for putting to rest many fundamental uncertainties and concerns in this area of law.

3. This Court's conclusion in *Weaver* that a "measure of control," 455 U.S. at 560, was an important factor in disqualifying a transaction from securities law coverage obviously has not settled the issue, nor provided clear practical criterion.

Ruefenacht's Active Participation In Continental's Business

The second important factual element of this case is the trial court's specific findings (after an evidentiary hearing) that Ruefenacht *was* "an active investor who intended to participate significantly in the management of the business," and was *not* a "passive investor who relied on others to manage the business." App. B at 48a-49a.

Granting certiorari here thus will allow the Court to examine a second fundamental question regarding application of the economic reality test, namely: What are the nature and limits of permissible activity in a business which is consistent with a claim of protection under the federal securities laws? In issue is the meaning and scope of that essential aspect of the test which requires a "security" transaction to involve "an investment in a common venture premised upon a reasonable expectation of profits *to be derived from the entrepreneurial or managerial efforts of others.*" *Forman*, 421 U.S. at 852 (emphasis added). The parameters of this aspect of the test also are a matter of uncertainty. *See, e.g., Forman*, 421 U.S. at 852, n.16; *Lino v. City Investing Co.*, 487 F.2d

689, 692 (3d Cir. 1973); *S.E.C. v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

No exposition of this aspect of the economic reality test is permitted by the facts of *Seagrave*, where the plaintiff/purchaser apparently was entirely "passive" and did not actually participate in the acquired company's business. However, the specific factual findings in this case, regarding Ruefenacht's active involvement in Continental's affairs, enable the Court to set needed parameters and practical guidelines, and thereby promote the certainty of application which is so acutely needed in this area.

II. The Writ Should Be Granted To Resolve The Conflict In Circuit Court Authority Regarding Issues Of Great Importance In Application Of The Securities Laws.

The conflict among the Circuit Courts of Appeal, which this Court acknowledged by granting certiorari in *Seagrave*, has been exacerbated by the Third Circuit's ruling here, and by the recent ruling of the Ninth Circuit in *Landreth Timber Co. v. Landreth*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,705, at 97,824 (9th Cir. March 7, 1984).[4]

These decisions present a split in Circuit Court authority which could not be more evenly divided. The Second, Third, Fourth, Fifth and Eighth Circuits[5] embrace a literal and reflexive application of the securities laws where "traditional" stock is involved in a transaction. These courts eschew any distinctions based upon the protective purposes of those laws, but instead cite the difficulty of drawing such distinctions as a reason for rejecting any case-by-case analysis. The inexorable result is that legions of commercial transactions which in no way implicate the protective purposes of the securities laws are subjected to those enactments. This authority, in short, exalts the form of a transaction over its economic substance, and thereby expands federal securities law coverage far beyond its intended scope.

In contrast, the Seventh, Ninth, Tenth and Eleventh Circuits[6] utilize a case-by-case analysis of a transaction's economic substance to determine whether the protective purposes of the securities laws are implicated, and whether a claimant for such protection belongs to that class of persons which Congress intended to afford federal relief. In this analysis, such courts consider the extent to which such a claimant has relinquished control of his investment, so as to be dependent upon the managerial or entrepreneural efforts of others for a return of profit—a situation whose abuse was the primary impetus for enactment of the securities laws. By such an approach these courts do *not* restrict coverage of the securities laws, but rather *conform* coverage to the intended ambit of the statutes.

The manifest result of this division is a patchwork of judicial authority whereby, paradoxically, national securities laws coverage is in many cases determined by the geographical locus of the parties or transaction.

The need for intervention by this Court is clear and compelling. The authority cited above, reflecting the debate as to the scope of the definition of "security,"

---

4. A petition for a writ of certiorari was filed on May 31, 1984 and is pending. *Landreth Timber Co. v. Landreth*, No. 83-1961.

5. *See supra* note 2.

6. *See supra* note 2.

shows only the tip of the iceberg of confusion which remains after the rulings in *Forman* and *Weaver*. Surely myriad unreported matters in district courts throughout the country have been diverted from the enforcement of substantive rights in order to choose sides in the debate. Moreover, and perhaps of greater importance, undoubtedly such pervasive confusion has adversely affected untold numbers of business transactions, the parties to which must guess as to the reach of the securities laws, and even as to the criterion by which the scope of those laws will be defined.

III. The Third Circuit's Ruling Conflicts With The Holdings of *Forman* and *Weaver*

Forman made clear that, while the economic reality test was first articulated in a case involving an investment contract, it in fact is "the basic principle that has guided all of [this] Court's decisions" applying the securities laws to particular transactions. *Forman*, 421 U.S. at 848.

Repeatedly in *Forman* this Court emphasized that application of the securities laws depends upon the substance or economic reality of a transaction, rather than the literal form of the instrument utilized, to wit:

> Because securities transactions are economic in character Congress intended the application of these statutes to turn on the *economic realities underlying a transaction*, and not on the name appended thereto.

421 U.S. at 849 (emphasis added).

***

> We perceive no distinction, for present purposes, between an "investment contract" and an "instrument commonly known as a 'security.' " In either case, the basic test for distinguishing the transaction from other commercial dealings is
>
> > "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301.
>
> This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a *security*. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

421 U.S. at 852 (footnote omitted) (emphasis added).

***

> What distinguishes a *security transaction*—and what is absent here—is an investment where one parts with his money in the hope of receiving profits from the efforts of others . . . .

421 U.S. at 858 (emphasis added).

These pronouncements clearly are concerned not simply with the definitions of "stock" and "investment contract," but rather with the definition of "security." *Forman* thus holds that in all cases application of the federal securities laws depends upon an economic analysis of each transaction, to the end of determining whether the claimant for federal relief is a member of the class of persons which those laws were intended to protect.

The Third Circuit erroneously rejected *Forman's* teachings, fundamentally on the rationale that *Forman* intended to distinguish between "traditional" and "non-traditional" securities. The source of this error is the Third Circuit's misinterpretation of *Forman's* reference to the "traditional" characteristics of stock. In the course of rejecting the literalist view that the name given an instrument is controlling of securities law coverage, this Court stated:

> In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

421 U.S. at 850-51.

Forman went on to conclude that there could be no such justifiable assumption by the lessees there, because the "stock" in issue had none of the characteristics "that in our commercial world fall within the ordinary concept of a security." *Id.* at 851, citing H.R. Rep. No. 85, 73d Cong., 1st Sess. 11(1933).

The above-quoted passage and the immediately following discussion in *Forman* led the Third Circuit, and has led other Circuits, to the erroneous conclusion that *Forman* intended to distinguish between "traditional" and "non-traditional" securities. Petitioner believes that such error has resulted from overreading and taking the above quote out of context, combined with misdirected zeal to uphold the "remedial" purposes of the securities laws.

These cases ignore the plain fact that *Forman's* reference to "traditional" stock or its characteristics was in the context of discussing a possible reliance claim, where a purchaser reasonably assumes the securities laws to apply. *Forman* left open the possibility that circumstances could exist where a justifiable expectation that the securities laws will apply to a transaction may create grounds for their application. Put another way, *Forman* stated that where a purchaser of "securities" not otherwise covered by federal law is "misled," 421 U.S. at 851, into believing that the federal securities laws apply, such a belief may justify invoking the protection of those laws. By the above quote and following discussion, *Forman* simply stated that such a claim is strengthened where "traditional" securities are involved, because it is more likely that such an expectation would be created in that circumstance.

The Third Circuit also failed to follow *Weaver*, which, in rejecting securities law coverage, applied an economic analysis to the two instruments there involved: a "traditional" certificate of deposit, and a private agreement between the parties. With respect to the issue of *when* the economic substance of a transaction must be examined, the Court stated explicitly and unmistakably that:

> *Each transaction* must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

455 U.S. at 560 n.11 (emphasis added).

Weaver thus reaffirms the ruling in *Forman* that the name affixed to an instrument does not control whether it is a "security"; rather, the economic realities of *each transaction* must be examined to determine securities law coverage.

CONCLUSION

This petition presents an opportunity for the Court to bring substantial certainty and predictability to the scope of the federal securities laws, an area which has suffered in confusion for nearly ten years since *Forman*. For this reason, and those discussed above, a writ of certiorari should issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit.

Respectfully submitted,
/s/ Robert C. Epstein
ROBERT C. EPSTEIN
Attorney for Petitioner
W. George Gould

HANNOCH, WEISMAN, STERN, BESSER,
BERKOWITZ & KINNEY, P.A.
744 Broad Street
Newark, New Jersey 07102
(201) 621-8800

DATED: July 26, 1984

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 83-5493

MAX A. RUEFENACHT

v.

CHRISTOPHER J. O'HALLORAN,
JOACHIM K. BIRKLE and
CONTINENTAL IMPORT & EXPORT, INC., and
W. GEORGE GOULD

CHRISTOPHER J. O'HALLORAN,
Third-Party Plaintiff,

v.

W. GEORGE GOULD, ESQ.,
Third-Party Defendant,

W. GEORGE GOULD,
Third-Party Plaintiff,

v.

DAVID BERNSTEIN,
AUTOBERN TRADING CO., INC.,
ERNEST STOECKLIN,
LENZENHOF GMBH
Third-Party Defendant,

MAX A. RUEFENACHT,
Appellant.

ON APPEAL FROM THE UNITED STATES
DISTRICT COURT FOR THE
DISTRICT OF NEW JERSEY
D.C. Civil No. 80-4097

ARGUED: May 14, 1984

BEFORE: GIBBONS and HUNTER, *Circuit Judges*, and RAMBO, *District Judge**

(Opinion Filed: June 11, 1984)

Peter S. Pearlman, Esq.,
Cohn & Lifland,
Park 80 Plaza West One,
Saddle Brook, N.J. 07662
Attorney for Appellant

Robert C. Epstein, Esq.,
Elizabeth A. Weiler, Esq.,
Hannoch, Weisman, Stern,
Besser, Berkowitz & Kinney, P.A.,
744 Broad Street,
Newark, N.J. 07102
Attorneys for W. George Gould

James T. O'Halloran, Esq.,
Tompkins, McGuire & Wachenfeld,
550 Broad Street,
Newark, N.J. 07102
Attorneys for Christopher J. O'Halloran

Of Counsel:
Robert. J. Kelly

*Honorable Sylvia H. Rambo, United States District Judge for the Middle District of Pennsylvania, sitting by designation.

Daniel L. Goelzer,
General Counsel
Jacob H. Stillman,
Associate General Counsel
Rosalind C. Cohen,
Assistant General Counsel
Lawrence W. Koltun,
Attorney,
Securities and Exchange Commission,
Washington, D.C. 20549
Amicus Curiae

Of Counsel:
Paul Gonson,
Solicitor

OPINION OF THE COURT
(Filed June 11, 1984)

GIBBONS, *Circuit Judge.*

This appeal requires that we determine whether stock transferred to effectuate the sale of all or part of a business is a "security" within the meaning of the 1933 and 1934 Securities Acts.[1] The district court, holding that the purchase or sale of 50 percent of the stock of a business is a security only if the transaction satisfies the "investment contract" or "economic reality" test of *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), entered summary judgment for the defendants. The plaintiff, and the Securities and Exchange Commission as *amicus curiae*, urge that

1. Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1982); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982).

the district court erred in applying the *Howey* test in these circumstances. The question whether the *Howey* test applies to the sale of stock having the traditional attributes of stock ownership is the subject of considerable academic commentary[2] and has produced a split of authority in the circuits.[3] Joining the Second, Fourth,

2. *See, e.g.*, Easley, *Recent Developments in the Sale-of-Business Doctrine: Toward a Transactional Context-Based Analysis for Federal Securities Jurisdiction*, 39 Bus. Law. 929 (1984) [hereafter Easley, *Recent Developments in the Sale-of-Business Doctrine*]; Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is Not a Federal Security Transaction*, 57 N.Y.U. L. Rev. 225 (1982); Seldin, *When Stock is Not a Security: The "Sale of Business" Doctrine under the Federal Securities Laws*, 37 Bus. Law. 637 (1982); Karjala, *Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security*, 1982 U. Ill. L. Rev. 413; FitzGibbon, *What is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 Minn. L. Rev. 893 (1980); Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 Hastings L.J. 219 (1974); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 Okla. L. Rev. 135 (1971); Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 Case W. Res. L. Rev. 367 (1967); Note, *Repudiating the Sale-of-Business Doctrine*, 83 Colum. L. Rev. 1718 (1983) [hereafter Note, *Sale-of-Business Doctrine*]; Comment, *A Criticism of the Sale of Business Doctrine*, 71 Calif. L. Rev. 974 (1983); Comment, *Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulation*, 8 Fla. St. U.L. Rev. 295 (1980).

3. The Second, Fourth, Fifth, and Eighth Circuits have rejected the sale-of-business doctrine. *see* Daily v. Morgan, 701 F.2d 496, 497-504 (5th Cir. 1983); Cole v. PPG Indus., Inc., 680 F.2d 549, 555-56 (8th Cir. 1982); Golden v. Garafalo, 678 F.2d 1139, 1140-47 (2d Cir. 1982); Coffin v. Polishing Machs., Inc., 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

The Seventh Circuit has taken the lead in applying the doctrine to the purchase of all or part of the stock of a business. *See* Sutter v. Groen, 687 F.2d 197, 199-204 (7th Cir. 1982); Canfield v. Rapp & Son, Inc., 654 F.2d 459, 463-66 (7th Cir. 1981); Frederiksen v. Poloway, 637 F.2d 1147, 1150-54 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). The Ninth, Tenth, and Eleventh Circuits have followed the Seventh Circuit's lead. *See* Landreth Timber Co. v. Landreth, [1984] Fed. Sec. L. Rep. (CCH) ¶ 99,705 (9th Cir. 1984); Christy v. Cambron, 710 F.2d 669, 672 (10th Cir. 1983); Kaye v. Pawnee Constr. Co., 680 F.2d 1360, 1366 n.2 (11th Cir. 1982); King v. Winkler, 673 F.2d 342, 344-46 (11th Cir. 1982). *See also* Chandler v. KEW, Inc., 691 F.2d 443, 443-44 (10th Cir. 1977).

Fifth and Eighth Circuits, we hold that the *Howey* test does not apply to the sale of all or part of a business effectuated by the transfer of stock bearing the traditional incidents of stock ownership. Thus we reverse.

I. Facts and Proceedings in the District Court

Continental Import & Export, Inc., is an importer of wines and spirits. Joachim Birkle is president of Continental and, until 1980, owned or controlled 100 percent of its stock. Ruefenacht, the plaintiff, alleges that early in 1980 he purchased 2500 shares of Continental's stock for $250,000—said to represent 50 percent of the company—in reliance on financial documents and other oral representations made by Birkle, Christopher O'Halloran, a certified public accountant, and W. George Gould, Continental's corporate counsel.

In deposition testimony, Ruefenacht asserted that the consideration for the price paid for Continental's stock

On one occasion this court applied the federal securities laws to the sale of 50 percent of the common stock of a close corporation without expressly addressing the applicability of the sale-of-business doctrine. Glick v. Campagna, 613 F.2d 31, 35 (3d Cir. 1979). *See also* Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 270-73 (3d Cir. 1978) (sale of controlling stock interest in corporate subsidiary constitutes sale of securities).

On the morning of oral argument in this case, the Supreme Court granted certiorari in a Second Circuit case rejecting the sale-of-business doctrine. *See* Seagrave Corp. v. Vista Resources, Inc., 710 F.2d 95 (2d Cir. 1983) (per curiam) (following *Golden v. Garafalo, supra*). *cert. granted*. 52 U.S.L.W. 3827 (U.S. May 14, 1984) (No. 83-1084).

included a promise be him to devote certain efforts to the firm's business. In conformance with that promise, Ruefenacht engaged in various activities on behalf of company. In the summer of 1980, for example, he solicited contracts to import beverages on behalf of the firm. On other occasions Ruefenacht participated in the hiring of company employees. He also applied for and received a state liquor license (or solicitor's permit), representing at that time that he would sell alcoholic beverages to wholesalers and receive in return a salary and compensation for expenses. On another occasion Ruefenacht signed a banking resolution denominating himself an officer of Continental. That resolution was signed at Birkle's request for the purpose of permitting Ruefenacht to sign corporate checks when Birkle was out of the country.

The record also reveals that Ruefenacht participated in the affairs of Continental in other minor ways He attended luncheon meetings, occasionally translated documents, maintained telephone contact with Continental employees on a regular basis, and visited warehouses considered for use by Continental. While engaging in these activities, however, Ruefenacht remained a full-time employee of another corporation. Moreover, his actions on behalf of Continental were at all times subject to the veto of Birkle.

After Ruefenacht paid $120,000 of the total $250,000 purchase price for Continental stock, he began to doubt the accuracy of certain representations made to him by Birkle and others. Soon thereafter he filed this action, alleging violations of sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 77l(2), 77q (1982), section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982), and Rule 10(b)(5), 17 C.F.R. § 240.10(b)(5) (1983). Ruefenacht charges that financial statements prepared by O'Halloran and signed by Birkle

overvalued Continental's goodwill and licenses by $243,000; that these financial statements assigned a $400,000 value to import or contract rights with no substantial worth; that the firm reported a surplus when in actuality it maintained a deficit; and that the defendants represented that net profits on sales between 1980 and 1981 would be $848,000 under a nationwide distribution program, and $1.197 million in the New York area, when in fact Continental was not seriously negotiating contracts for nationwide distribution at all and could not reasonably project these net earnings. In reliance on these representations, Ruefenacht alleges, he had purchased 1000 shares of Continental's stock and had advanced $120,000 to Birkle. The Complaint seeks rescission and restoration of the amount paid. Ruefenacht also pleads pendent state claims for fraud and breach of fiduciary duties.[4]

The district court granted summary judgment for defendants, concluding that the stock purchased by Ruefenacht was not a "security" within the meaning of the 1933 and 1934 Acts. The court so concluded not because the instrument purchased by Ruefenacht lacked any of the indicia of stock ownership; indeed, the court conceded that the "stock which Ruefenacht received contains all the attributes mentioned by the *Forman*[5] Court as indicating that the transaction did involve a security." App. at 220. Rather, the court held, the instrument was not a "security" because of the degree of Ruefenacht's control over Continental's business. "Because Mr. R[ue]fenacht intended to jointly manage Continental

---

4. Gould has impleaded Autobern Trading Corp., Ruefenacht's full-time employer. Bernstein and Stoecklin, associates of Birkle and Ruefenacht, and Lenzenhof GmbH, a German Corporation controlled by Birkle, Birkle and Continental have defaulted.

5. United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975).

with Mr. Birkle," the district court reasoned, "he did not purchase 'securities' as defined in the federal acts." App. at 309. Finding no federal jurisdiction over the securities claims, the district court dismissed the complaint in its entirety.

II. History of the Sale-of-Business Doctrine

The 1933 and 1934 Securities Acts include within the definition of "security" a series of specific terms—*e.g.*, "note," "stock," "bond," and "debenture"—and thereafter employ a number of more general phrases—*e.g.*, "investment contract," "any interest or instrument commonly known as a 'security.' "[6] As early as 1943 the Supreme Court held that certain novel economic transactions were encompassed within these latter, more generic terms, even though not embraced by their more specific provisions like "stock," "bond," or "note." *See SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 348-55 (1943) (holding that leasehold interests in property adjacent to exploratory oil wells were "securities"). The Court's leading opinion on this point, *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), held that agreements for the sale of a citrus crop coupled with optional service contracts were "investment contracts." *Howey* propounded a definition of "investment contract" derived from descriptions widely employed in state "blue sky" laws: an investment contract, the Court held, is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ." *Id.* at 298-99. This definition came to be known as the "*Howey* test" and led many courts to clas-

6. 15 U.S.C. §§ 77b(1). 78c(a)(10) (1982). These definitions are subject to many important qualifications: the definitions and their qualifications are examined in greater detail in Part III A *infra*.

sify a variety of novel economic schemes as "investment contracts."[7]

While the court were giving the term "investment contract" a broad compass, the more specific term "note" was read narrowly, so as not to embrace every instrument comporting with the Acts' terms that is technically a "note" under state law. The first appellate holding that not every such "note" is a "security" under the federal Acts is this court's decision in *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973).[8] In *Lino*, this court held that a personal promissory note tendered as partial consideration for rights under a franchise agreement was not a "note" under the federal Acts. *Id.* at 693-96. Significantly, we did not apply the *Howey* test to the notes in question, as Part I of the opinion pointedly made clear by applying the *Howey* test to the franchise agreements themselves. *Id.* at 691-93. Rather, we examined the entire context of the note transactions, declining at that time to expound "a 'test' . . . that would aid in determining whether there has been a purchase or sale of securities when a personal promissory note is involved." *Id.* at 696 n.15.

Following *Lino's* lead, several courts strove to define the circumstances under which a "note" should be considered a "security" under the Securities Acts. The Fifth

7. *E.g.*, Smith v. Gross, 604 F.2d 639, 642-43 (9th Cir. 1979) (per curiam) (earthworms); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414, 416-18 (8th Cir. 1974) (chinchillas); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478-85 (5th Cir. 1974) (cosmetics); SEC v. Glenn W. Turner Enters., 474 F.2d 476, 480-83 (9th Cir.) (self-improvement courses), *cert. denied*, 414 U.S. 821 (1973).

8. *See* Exchange National Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1134 (2d Cir. 1976) (Friendly, J.) (acknowledging *Lino* as first appellate holding to narrow the breadth of "note" under the federal Acts).

Circuit sought to determine whether a note comprised an "investment."[9] The Ninth Circuit approached the problem on a slightly different tack, seeking to determine whether the lender supplies "risk capital" to the maker.[10] In a leading opinion written by Judge Friendly, the Second Circuit rejected both of these approaches. *See Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976) (Friendly, J.). In part the Second Circuit feared that the "investment" and "risk capital" tests obliterated Congress' carefully drawn distinctions among those notes included within and excluded from the Acts. Congress took care to provide that any note arising out of a "current transaction" and having a maturity not exceeding nine months was excluded from the registration provisions, but included in the antifraud provisions, of the 1933 Act;[11] and that any note with a maturity not exceeding nine months was excluded from the 1934 Act.[12] As the Fifth Circuit candidly acknowledged, its "investment test" "virtually writes [these

9. In a discussion not entirely free of self-defining terms, the Fifth Circuit characterized a "note" under the federal Acts as either (1) "offered to some class of investors," (2) "acquired for speculation or investment," or (3) exchanged to "obtain investment assets, directly or indirectly." McClure v. First Nat'l Bank of Lubbock, 497 F.2d 490, 493-94 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *see also* Bellah v. First National Bank of Hereford, 495 F.2d 1109, 1111-13 (5th Cir. 1974) (adopting distinction between "investment" and "commercial" loan).

10. Great Western Bank & Trust Co. v. Kotz, 532 F.2d 1252, 1257 (9th Cir. 1976). Six factors bore on the Ninth Circuit's analysis: (1) "time," (2) "collateralization," (3) "form of the obligation," (4) "circumstances of issuance," (5) relationship between the amount borrowed and the size of the borrower's business," and (6) "contemplated use of the proceeds." *Id.* at 1257-58 (emphasis omitted).

11. 15 U.S.C. §§ 77c(a)(3), 77q(c) (1982).

12. 15 U.S.C. § 78c(a)(10) (1982). *See* Part III A *infra*.

distinctions] out of the law." *McClure v. First National Bank of Lubbock*, 497 F.2d 490, 494 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). In addition, the Second Circuit expressed concern over the uncertainty that would inevitably follow from a weighing of factors "without any instructions as to [their] relative weights." *Exchange National Bank*, 544 F.2d at 1137. In lieu of the "investment" and "risk capital" approaches, the Second Circuit enumerated a family of note transactions presumptively excluded from the Act—all concerning consumer financing or business financing of current costs—and held that other notes not bearing the family pedigree were presumptively securities under federal law.[13]

There matters stood when late in 1976 the Seventh Circuit held that the *Howey* test for "investment contract" applies to determine whether a "note" is a security under the Acts. *Emisco Industries, Inc. v. Pro's Inc.*, 543 F.2d 38, 39-40 (7th Cir. 1976). The extension of *Howey*

13. Judge Friendly wrote:

> One can readily think of many cases where [the context requires that a note is not within the Act]—the note dlivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized). When a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, § 10(b) of the 1934 Act should generally be held to apply.

544 F.2d at 1138 (footnote omitted). Recently the Second Circuit added a new member to this family: notes evidencing loans by commercial banks for current operations. *See* Chemical Bank v. Arthur Anderson & Co., 726 F.2d 930, 939 (2d Cir. 1984) (Friendly, J.).

into the note arena was problematical. This application of *Howey* further obliterated the special statutory distinctions drawn by Congress among notes included in and excluded from the Acts, and injected into the note area the same uncertainty that pervades litigation over the inherently vague term "investment contract." Moreover, the Seventh Circuit doctrine seemed to ignore some important statutory policies underlying the securities Acts. As the legislative history makes abundantly clear,[14] one such policy is the protection of "investors"; and to the extent that *Howey* maps the entire set of "investors" marked for protection—not an obviously correct assumption—then that policy may be satisfied. But a second policy of the Acts is, as we observe below, the protection of the marketability of certain instruments of commerce, whether or not purchased by "investors" under the *Howey* formula. Among the favored instruments, for example, is certain commercial paper.[15] Several com-

14. *See* note 33 *infra*.

15. The SEC regards commercial paper as exempt from the *registration* provisions of the 1933 Act, *see* 15 U.S.C. § 77c(a)(3) (1982), only if the paper is:

> prime quality negotiable paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well-recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve Banks.

Securities Act Release No. 4412, 26 Fed. Reg. 9158, 9159 (1961); *see* 17 C.F.R. § 231.4412 (1983). Commercial paper is not exempt from the *antifraud* provisions of the 1933 Act. *See* 15 U.S.C. § 77q(c) (1982); Part III A *infra*.

Most courts have applied the criteria of Release 4412 to the 1934 Act exemption as well. *E.g.*, Mallinckrodt Chem. Works v. Goldman, Sachs & Co., 420 F. Supp. 231, 240 (S.D.N.Y. 1976); Alton Box Board Co. v. Goldman, Sachs & Co., 418 F. Supp 1149, 1157 (E.D. Mo. 1976) (citing *Levy infra*), *rev'd on other grounds*. 560

mentators have perceptively remarked that an application of the "investment" or "*Howey*" tests to these commercial instruments would undermine federal protection for many instruments most deserving of coverage.[16]

Notwithstanding these concerns, in 1981 the Seventh Circuit extended the *Howey* or "economic reality" test to the purchase or sale of *stock*. *Frederikson v. Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). While the extension of the *Howey* test to the note area had ben greeted with some concern, the further extension of that doctrine to the purchase or sale of stock sparked a considerable amount of alarm.[17] While the difficulties attending the simple extension of *Howey* to notes still applied, two other difficulties loomed even larger.

First, at least in the note area there is, as we held in *Lino*, some necessity for fine-tuning the definition of "note" to avoid sweeping within the coverage of section

F.2d 916 (8th Cir. 1977); Franklin Savings Bank v. Levy, 406 F. Supp. 40, 43-44 (S.D.N.Y. 1975), *rev'd on other grounds*, 551 F.2d 521, 527-29 (2d Cir. 1977); Welch Foods v. Goldman, Sachs & Co., 398 F. Supp. 1393, 1397-98 (S.D.N.Y. 1974). *See generally* Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 Bus. Law. 1567, 1574 & nn. 27-28, 1586-87 & n.86 (1980); Note, *The Commercial Paper Market and the Securities Acts*, 39 U. Chi. L. Rev. 362, 380-401 (1972) [hereafter Note *Commercial Paper*].

16. *See* Sonnenschein, *supra* note 15, 35 Bus. Law. at 1595 & n.131; Coffey, *supra* note 2, 18 Case W. Res. L. Rev. at 381-403; Hannan & Thomas, *supra* note 2, 25 Hastings L.J. at 219-53.

17. *E.g.*, Daily v. Morgan, 701 F.2d 496 (5th Cir. 1983); Cole v. PPG Indus., Inc., 680 F.2d 549 (8th Cir. 1982); Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982); Coffin v. Polishing Machs., Inc., 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 8868 (1979). For incisive academic commentary, see Note, *Sale-of-Business Doctrine*, *supra* note 2, 83 Colum. L. Rev. 1718 (1983); Comment, *A Criticism of the Sale of Business Doctrine*, 71 Calif. L. Rev. 974 (1983).

10(b) of the 1934 Act every consumer and business loan financing current operational costs. But there is no such necessity in the stock area. Stock is a well-defined term, is not issued by consumers, and is not ordinarily employed by business to finance current transactions. While the importation of the *Howey* test into the note arena might be justified as an expedient—albeit an imperfect one—for limiting the definition of "note," no such expedient seems necessary for the issue of stock.

Second, because the *Howey* test turns in part on whether the purchaser derives profits "from the entrepreneurial or managerial efforts of others," *see United Housing Foundation, Inc. v. Forman*, 421 U.S. 834, 852 (1975), a central aspect of the test, when applied to stock, requires a determination whether the purchaser exercises a controlling share of the corporation.[18] A controlling share may be exercised with less than 100 percent stock ownership—indeed, at times with far less than 50 percent ownership. *See Sutter v. Groen*, 687 F.2d 197, 203 (7th Cir. 1982). Thus an instrument might be transformed from a security into a non-security by virtue of a small increase in the number of shares traded. Instruments purchased by multiple investors might be securities as to some purchasers and non-securities as to others, or securities as to sellers but not as to purchasers.[19] Instruments might be securities if traded in a series of small transactions but non-securities if the same transaction is effectuated in a single sale. To many judges and lawyers with up to 50 years of experience with the securities laws, these seemed extraordinary consequences.[20]

---

18. *See, e.g.*, Thompson, *supra* note 2, 57 N.Y.U. L. Rev. at 253-61, Seldin, *supra* note 2, 37 Bus. Law. at 661-62.

19. *See* McGrath v. Zenith Radio Corp., 651 F.2d 458, 467-68 n.5 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981).

20. Until recently, courts expressed little doubt that the sale of 100 percent of the stock of a business (and *a fortiori* less than 100 percent) constituted the sale of a "security" under the Acts. *See* Occidental Life Ins. Co. v. Pat Ryan Assocs., Inc., 496 F.2d 1255, 1261-63 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); Spencer Cos. v. Armonk Indus., Inc., 489 F.2d 704, 707 (1st Cir. 1973) (denying preliminary injunction but assuming stock was a security); Alberto-Culver Co. v. Scherk, 484 F.2d 611, 615 (7th Cir. 1973), *rev'd on other grounds sub nom.* Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974); Walling v Beverly Enters., 476 F.2d 393, 395 (9th Cir. 1973) (exchange of all common stock).

The parties appear to have assumed that the sale of 100 percent of the stock of a firm constitutes the sale of a "security" in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971). There ther Supreme Court doubted whether a non-purchaser/non-seller (Manhattan Casualty Co.) had standing to invoke the Acts, *see id.* at 13-14 n.10, a question later settled in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). No party at any stage of the litigation, however, appears to have questioned that the stock constituted a "security."

The case now before us illustrates just how far the extension of *Howey* from investment contract to note to stock may be taken. Ruefenacht is the purchaser of 50 percent of the stock of Continental. Had he purchased only 49 percent, Ruefenacht would presumably have lacked corporate control, rendering the instrument purchased (at least presumptively) a security. Had he purchased 51 percent, in contrast, the instrument would presumptively not have been a security. Both presumptions, of course—at least under the Seventh Circuit approach, *see Sutter*, 687 F.2d at 203—would have been subject to rebuttal. Because Ruefenacht purchased exactly 50 percent, a more sophisticated analysis would presumably be required—although just what that analysis should be is less than obvious.

III. The Securities Acts as Interpreted by the Supreme Court

If Congress or the Supreme Court has mandated these results, then, regardless of their deficiencies in logic, we

would be bound to apply them. We turn, therefore, to the language, history, structure, and policies of the 1933 and 1934 Acts. Then we consider the impact of recent Supreme Court Decisions.

A. *Statutory Language, Structure, and History*

1. *The definition and exemption provisions*

Section 2(1) of the 1933 Act as amended provides that the term "security"

> means any note, stock, treasury stock, bond, debenture, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a "security". . . .

15 U.S.C. § 77b(a) (1982). The legislative history to section 2(1) indicates that Congress cast the definition of security "in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security." H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933).

Although Congress intended that the term "security" embrace those instruments that "fall within the ordinary concept of a security," several important qualifications limit this definition. Preceding all of the definitions in the 1933 Act is the clause "unless the context otherwise requires." The significance of the so-called "context clause" is addressed in Part III A 3 *infra*.

In addition, section 3 of the 1933 Act defines a number of important "exempted securities." Among the defined exemptions in the 1933 Act is an exception for short-term notes. Section 3(a) provides that the Act shall not apply to:

> Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction

> . . . and which has a maturity at the time of issuance of not exceeding nine months . . . .

15 U.S.C. § 77c(a)(3) (1982). As one commentator has observed. Congress intended the short-term note exemption to free from the Act's registration requirements prime quality commercial paper sold to knowledgeable investors. The necessity for disclosure in a registration statement to these investors was less vital than for sales of other, more speculative paper to other, less knowledgeable buyers.[21] Congress did not, however, include the "commercial paper" exception in the antifraud provisions of the 1933 Act. *See* 15 U.S.C. § 77q(c) (1982).

The 1933 Act also empowers the Commission to grant additional exemptions. Section 3(b) of the Act as amended provides that:

> The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $5,000,000 [then $100,000].

15 U.S.C. § 77c(b) (1982). Congress envisioned that the Commission's exemption power would be reserved for "needless registration of issues of such an insignificant

---

21. *See* Note, *Commercial Paper*, *supra* note 15, 39 U. Chi. L. Rev. at 384. Accordingly, the Commission requires that, in order to qualify for the section 3 exemption to registration, short-term commercial paper be of prime quality and of a kind not marketed to the general public. *See* note 15 *supra*.

character as not to call for regulation." H.R. Rep. No. 85, *supra*, at 15. According to the House Report, however, the Commission's exemption power was carefully limited by the prohibition on exemptions for issues larger than $100,000 (now $5,000,000), "thus safeguard[ing] against any untoward pressure to exempt issues whose distribution may carry all the unfortunate consequences that the act is designed to prevent." *Id.*

The definition of "security" under the 1934 Act parallels that under the 1933 Act. Section 3(a)(10) of the 1934 Act provides that " 'security' means any note, stock, treasury stock, bond, debenture, . . . investment contract, . . . or in general, any instrument commonly known as a 'security.' " 15 U.S.C. § 78c(a)(10) (1982).[22] One important distinction between the 1933 and 1934 Act definitions pertains to short-term notes: generally speaking, short-term notes that would be exempt from the registration provisions of the 1933 Act are exempted from the antifraud provisions of the 1934 Act.[23] And like the 1933 Act, section 3(a)(12) of the 1934 Act authorizes the SEC to grant additional exemptions for classes of securities either unconditionally or upon specialized terms and conditions.[24] 15 U.S.C. § 78c(a)(12) (1982).

---

22. A Senate Report describes these definitions as "substantially the same." S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934). *See* United Housing Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975); Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967).

23. The subtle distinctions in short-term note coverage under the Acts is examined in Note, *Commercial Paper*, *supra* note 15, 39 U. Chi. L. Rev. at 380-401; and in *Exchange National Bank*, *supra*, 544 F.2d at 1131-32. *See* note 15 *supra*.

24. Section 3(a)(12) as amended provides:

> The term "exempted security" or "exempted securities" included . . . such other securities . . . as the Commission may, by such rules and regulations as it deems consistent with the public interest and the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this chapter which by their terms do not apply to an "exempted security" or to "exempted securities".

15 U.S.C. § 78c(a)(12) (1982).

Nowhere in these provisions is there an exemption for the sale of a controlling share of corporate stock. This conspicuous omission is significant for two reasons. First, Congress took pains to exempt certain commercial paper from the class of "notes" covered by the registration provisions of the 1933 Act and the antifraud provisions of the 1934 Act. When Congress wished to exempt a class of instruments from some or all of the Acts' provisions, it had little trouble in doing so expressly.[25] And while it might be argued that purchasers of large blocks of stock, often in face-to-face transactions, are more knowledgeable than the average investor—and therefore often less in need of protection—the same argument applies to the commercial paper exception. Congress exempted certain commercial paper in part because it is high-grade and purchased by knowledgeable investors; accordingly, the SEC approves for exemption only that commercial that is "prime quality" and "of a type not ordinarily purchased by the general public." *See* note 15 *supra*. These arguments persuaded Congress to exempt prime quality commercial paper expressly. Congress did not, however, exempt particular stock transactions. Moreover, while Congress may not have considered the sale of all or part of a business by means of a stock purchase under the 1933 Act—the Act is, of course, primarily addressed to "public offerings," *see* 15 U.S.C. § 77d(2) (1982) (private offering exemption), and the sale of a business is fre-

---

25. *Cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733-34 (1975) (noting distinction between "*purchase* or sale" in § 10(b) of 1934 Act and "*offer* or sale" in § 17(a) of 1933 Act, and stating, "When Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly."); *see also* Touche Ross & Co. v. Redington, 442 U.S. 560, 572 (1979); Southeastern Community College v. Davis, 442 U.S. 397, 411 (1979).

quently not effectuated by a "public offering"—the same cannot be said of the 1934 Act. It was always clear that the 1934 Act would, by its terms, apply to stock purchases comprising controlling corporate shares. Nor can it be said that Congress did not envisage face-to-face transactions; it has always been clear that the Act applies to face-to-face sales of stock as well as to transactions in the recognized markets. *See Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982); *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 10, 12 (1971) ("Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face").[26]

Second, Congress vested in the SEC the responsibility for identifying certain securities for exemption. In addition, Congress empowered the SEC to attach conditions to any exemptions granted in order to protect the investing public. These decisions suggest that in the judgment of Congress the Commission, and not the courts, has the expertise and practical experience required to ensure that exemptions to the Act are prudently chosen, and that appropriate conditions are attached to any exemptions granted. Needless to say, the SEC has never exempted the purchase or sale of a controlling share of corporate stock from the definition of security. Thus we look on the plea that this court do so with some skepticism.

2. *Text of the definitions and early interpretations*

The definition of "security" under both Acts begins with an enumeration of specific terms—"note," "stock," "bond," "debenture"—and then proceeds to more general phrases, including "investment contract." This procession from the specific to the general did not escape the Supreme Court's attention on its first occasion to consider the definition of "security." In *SEC v. C.M. Joiner Corp.*, 320 U.S. 344 (1943), the Court observed:

> In the Securities Act the term "security" was defined to include by name or description many documents in which there is common trading for speculation or investment. Some, such as notes, bonds, and stocks, are pretty much standardized and the name alone carries well-settled meaning. Others are of more variable character and were necessarily designated by more descriptive terms, such as "transferable share," "investment contract," and "in general any interest or instrument commonly known as a security." *We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents.* Instruments may be included within any of these definitions, as a matter of law, if on their face they answer to the name or description. However, the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as [a] matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character as "investment contracts," or as "any interest or instrument commonly known as a 'security.' "

320 U.S. at 351 (emphasis added). Thus, the Supreme Court recognized that instruments like "stock," "bonds," and "notes" answer "on their face . . . to the name or description." The Acts' latter phrases, intended to supplement these common instruments, were devised to capture "[n]ovel, uncommon, or irregular devices" that were not so readily classified. This construction is consistent with the fact that the terms "stock," "bond," and "note" had well-defined meanings under state corporate

26. *See also* Daily v. Morgan, 701 F.2d 496, 502 (5th Cir. 1983); Golden v. Garafalo, 678 F.2d 1139, 1146-47 (2d Cir. 1982).

law that Congress obviously had incorporated by reference, and that Congress did not intend the reach of the Act to stop with these well-defined terms alone.

The Court's next bout with the definition of security confirmed that the phrase " 'investment contract" also drew on state law for its content. In *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the Supreme Court held that in the words "investment contract" Congress had employed a term "common in many state 'blue sky' laws." *Id.* at 298. Despite Justice Frankfurter's position in dissent that the phrase " 'investment contract' is not a term of art," *id.* at 301 (Frankfurter, J., dissenting), the Court held that by "including an investment contract within the scope of [the Act], Congress was using a term the meaning of which had been crystallized by [state] judicial interpretation[s]." *Id.* at 298. These state definitions, the Court held, "had been broadly construed by state courts so as to afford the investing public a full measure of protection." *Id.*

Thus, by 1946 it was plain that the definitions in the 1933 and 1934 Act drew on state law for their content, and that in order to embrace novel or unusual investment schemes within the salutary provisions of the Acts, Congress supplemented standard state-law definitions of "stock," "note," etc., with more general phrases, including "investment contract," drawn from state law. *Joiner* and *Howey* make plain that Congress did not intend to *circumscribe* the scope of the standard terms—"stock," "note," "debenture"—to that of the more generous phrases. To the contrary, that construction would turn the history of the Acts and the state-law definitions on their heads. Congress never intended that "stock" that did not also satisfy the definition of "investment contract" would not be within the Acts' terms. Rather, Congress intended that "investment contracts" that did not

also satisfy the definition of "stock" *would be* within the Acts' terms. See *Tcherepnin v. Knight*, 389 U.S. 332, 342 (1967) (*Joiner* "rejected the respondents' invitation to 'constrict the more general terms substantially to the specific terms which they follow' ").

The language of the definition itself makes this consideration clear. As the Second Circuit recently noted, there would have been little reason for the drafters to have employed words like "stock," "bond," and "note"—which had clear definitions under state law—if their intention had been to include only those instruments that satisfied an economic reality" test appropriate to the latter terms. If an economic reality test appropriate to these subsequent terms were intended, "a substantial portion of each class of instrument would, in fact, not be within the definition." *Golden v. Garafalo*, 678 F.2d 1139, 1144 (2d Cir. 1982).

To be sure the *Howey* Court also admonished that "[f]orm was [to be] disregarded for substance" and that "emphasis was [to be] placed upon economic reality." 328 U.S. at 298. Those words were written, however, in the context of disregarding the absence of a label like "stock" or "note" when novel schemes nonetheless constitute "investments" earnings profits from the labor of others. They did not direct us to ignore the presence of an instrument that, as a matter of economic reality, is "stock" simply because it is not purchased by one who also entered into an "investment contract."

In summary, neither the language, the history, the structure, nor the Acts' early interpretations suggest that the transfer of stock to effectuate the sale of all or part of a business is not the purchase or sale of a "security." And several considerations—particularly Congress' express treatment of notes and its conferral on the SEC of the power to specify exempt securities—suggest the contrary.

We now consider the impact of the "context clauses" on our analysis.

3. *The "context clauses"*

Each of the definitional sections of the 1933 and 1934 Acts begins with the words, "When used in this [sub]-chapter, unless the context otherwise requires—." 15 U.S.C. §§ 77b, 78c(a) (1982). These clauses, the defendants maintain, authorize us to narrow the definition of "stock" as the "economic realities" require. In considering this position, we turn to the history and function of the clauses.

Perhaps the most notable feature about the "context clauses" is that they do not appear in the paragraphs defining "security" at all. Instead, these clauses precede all fifteen definitions in the 1933 Act and all forty definitions in the 1934 Act. Plainly, the "context clauses" were not directed particularly at the definition of "security." This lack of particular application is underscored by the legislative history of the definitions of "security." In neither the House nor the Senate reports, for example, did the drafter allude to the clauses or indicate that particular kinds of stock, notes, or debentures are embraced by the Act "only when the context requires." If the drafters had indeed intended that the context clause exempted certain named securities from coverage, they certainly made no mention of it.

The legislative evolution of the 1933 Act suggests even more strongly that the context clauses had no such purport. Section 2 of the Senate version of the 1933 Act provided, "When used in this Act the following terms shall, *unless the text otherwise indicates*, include the following respective meanings." H.R. 5480, 73d Cong., 1st Sess. 39 (1933) (emphasis added) (as enacted by the Senate on May 10, 1933); S. 875, 73d Cong., 1st Sess. 1 (1933). This Senate bill tracked the language of an early

House bill, H.R. 4314, which had also opened with the phrase "unless the text otherwise indicates." H.R. 4314, 73 Cong., 1st Sess. 2 (1933). Early in the legislative process, however, the House Committee on Interstate and Foreign Commerce substituted the language "unless the context otherwise requires" for the phrase "unless the text otherwise indicates. *See* H.R. 5480, 73d Cong. 1st Sess. 1 (1933) (as enacted by the House on May 5, 1933). Ultimately the Conference Committee adopted the House version. Although the Conference Committee Report dicusses a number of significant distinctions between the House and Senate definitions, the Report makes no mention of the difference between these prefatory clauses. *See* H. Conf. Rep. No. 152, 73d Cong., 1st Sess. 24-25 (1933).

It seems evident that the drafters did not attribute particular significance to the distinction between these House and Senate phrases. The "text" to which the Senate had adverted was obviously the text of the statute itself. Similarly, the "context" to which the House referred was obviously the context in which the defined words appear in the statute itself. Both the House and Senate provisions were intended to direct that the ensuing definitions were to be used throughout the statute unless the text of the Act expressly, or another section of the statute implicitly, made them inapplicable to that section.[27]

---

27. The commentators are in general agreement with this interpretation. *See* Sonnenschein, *supra* note 15, 35 Bus. Law. at 1577-78 & n.44; Hannan & Thomas, *supra* note 2, 25 Hastings L.J. at 277-79; 2 L. Loss, Securities Regulation 1698, 1705 (2d ed. 1961); 4 L. Loss, Securities Regulation 2485 (2d ed. Supp. 1969). The Commission also has interpreted the "context clauses" to refer to the context in which the defined terms appear in the Acts. *See* 1 L. Loss, Securities Regulation 215, 524-25, 533, 642-43 (2d ed. 1961); 2 *id.* at 1696 n.33. Moreover, the Supreme Court too has interpreted the clause in this fashion. *See* SEC v. National Securities, Inc., 393 U.S. 453 (1969):

The defendants, however, would have us attribute a very different meaning to the "context" language. That language, they assert, refers not only to the statutory context but to the context of the *underlying factual transaction*.[28] Thus, they argue, the House and Senate versions of the 1933 Act had very different meanings. The Senate version, of course, would not have admitted of the defendants' interpretation, for it would have authorized exceptions as "the text otherwise indicates," not as the factual circumstances seem to warrant. The House version, in contrast, as the defendants construe it, sanctioned a wide-ranging exemption power varying with the facts and circumstances. It strikes us that if the conferees had observed so considerable a distinction between the House and Senate bills and had selected the broader, House version, they would at least have remarked upon so important a subject. Moreover, a wide-ranging exemption power is inconsistent with the Act's conferral of exemption power on the SEC. Because the Act conferred a narrowly tailored exemption power on the Commission, it seems extraordinary that the conferees should not have remarked upon a decision to confer a potentially broader power through the context clause.

These considerations lead us to conclude that the context clauses themselves do not authorize judicial exclu-

---

Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase "unless the context otherwise requires."

Id. at 466. *See also* note 29 *infra*.

28. The Seventh Circuit has espoused this "factual context" position. *See* Emisco Inds., Inc. v. Pro's Inc., 543 F.2d 38, 39 (7th Cir. 1976); C.N.S. Enters., Inc. v. G & G Enters., Inc., 508 F.2d 1354. 1357-62 (7th Cir.). *cert. denied*, 423 U.S. 825 (1975).

sions of securities from the scope of the Act when the "factual circumstances" seem to warrant it. Of course, we do not thereby adopt a wooden approach to statutory construction. The Supreme Court has often admonished that a "thing may be within the letter of the statute and yet not within the statute." *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975) (quoting *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892)). We simply observe that Congress did not intend the context clause as a font of authority to narrow the compass of the term "stock" when the underlying facts may seem to warrant. If that result is to obtain, it must devolve from some other indication in the language, structure, or legislative history of the Acts. The context clause alone is no such authority.[29] As Judge Friendly has written, "[s]o long as the statutes remain as they have been for over forty years, courts had better not depart from their words without strong support for the conviction that, under the authority vested in them by the 'context' clause, they are doing what Congress wanted when they refuse to do what it said." *Exchange National Bank*, 544 F.2d at 1138.

IV.

A. *Policy Considerations*

As additional guides to Congress' intent, we examine the reasons and policies that gave rise to protection of securities under the 1933 and 1934 Acts.

---

29. *See, e.g.*, Marine Bank v. Weaver, 455 U.S. 551 (1982), holding that a certificate of deposit was not a security under the federal securities Acts because it enjoyed sufficient protection under the banking laws. *Id.* at 558-59. Alhough the Court relied in part on the context clause, its holding was independently supported by the legislative history and structure of the banking laws and securities Acts.

1. *Uncertainty of application*

The most prominent feature of the sale-of-business doctrine is its attendant uncertainty of application, and for that reason we address this feature first. We agree with the Seventh Circuit that corporate control may be exercised with less than 100 percent of the outstanding stock of a firm, and therefore that if the sale-of-business doctrine is to be applied, it must logically be extended to all such purchases and sales. *Sutter v. Groen*, 687 F.2d 197, 203 (7th Cir. 1982). No doubt, for example, the doctrine must be applicable with equal rigor to the purchase of 15 percent of a firm's stock as to the purchase of all 100 percent. This conclusion raises the specter of examining, in every securities transaction, the niceties of corporate control. Such an examination would be no small task. Control may be exercised, for example, by alliances of minority shareholder factions. One indicator of whether a minority share effectively exercises control might be whether the purchase price of the share exceeded the prevailing market price. Another might be the voting patterns of various factions. Yet another might be the extent of management involvement by the faction, including, for example, whether various management employees were appointed by or are allied with that faction. And of course, testimony might be taken on the intent of the purchasers and the realities of corporate management. Even a purchaser who acquires more than 51 percent of the stock may not control with respect to certain corporate modifications for which the certificate of incorporation or state law may require supermajorities. *E.g.*, 8 Del. Code Ann § 102(b)(4) (1983). One commentator urges that even a buyer of 100 percent of the stock of a firm should be accorded the protections of the Acts "[i]f this party can prove he intended to be, and thereafter remained, a passive investor." Easley, *Recent Developments in the Sale-of-Business Doctrine*, *supra* note 2, 39 Bus. Law. at 971-72. Wholly apart from the

oddity of making what a security *is* depend upon these factors, they raise the prospect of a substantial hearing in many cases simply to determine whether an instrument is a "security."

The Seventh Circuit acknowledges the uncertainty that would flow from this investigation, but discounts it. To interpret the Acts as creating private rights of action in favor of "entrepreneurs," the Seventh Circuit has reasoned, "is to go awfully far for the sake of having to make some distinctions." *Sutter*, 687 F.2d at 202. We are not as placid about this prospect as is the Seventh Circuit. After all, the costs of legal rules accrue not only to the courts but to those members of the public who must structure their affairs accordingly. Counsel must be hired to predict whether the purchase of a large block of stock will render it a security or a non-security. Doubts will be created over whether registrations are necessary. All of this uncertainty has real economic costs. It is one thing, if the sale-of-business doctrine were capable of clear application, to say "caveat emptor" and let the market price reflect that the purchaser no longer has federal protection from fraudulent representations. But it is another thing if the buyer and seller are unable to predict readily whether their instruments are "securities" at all. That uncertainty raises the cost of economic transactions, inhibits the flow of capital, spawns litigation, and in general benefits neither the parties nor the courts.[30]

2. *Marketability of instruments and necessity for protection*

A concern related to the uncertainty of application is the marketability of certain favored instruments. The

30. *See* Daily v. Morgan, 701 F.2d at 503; Golden v. Garafalo, 678 F.2d at 1145-46; Note, *Sale-of-Business Doctrine*, *supra* note 2, 83 Colum L. Rev. at 1741-44.

Acts apply not only to the sale of stock on the nationally recognized markets, but to the sale of "notes," "bonds," "debentures," and other instruments sold in non-market transactions. *See Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982). Certain commercial paper, for example, is illustrative. *See* note 15 *supra*. In favoring these widely recognized instruments, Congress reduced the transaction costs associated with their transfer; buyers may rely on the accuracy of representations made without instituting expensive investigations into information over which the seller has knowledge and control, and without demanding a premium price to reflect the risk of fraudulent representation This protection facilitates the ready sale of instruments in interstate commerce.

The sale of a business by means of stock is such a transaction. As the Fifth Circuit has observed,

> there are special risks involved in the sale of stock in a corporation that might justify special protection. Generally speaking, one who purchases the assets of a business is not liable for its debts and liabilities, while one who purchases the stock in a corporation—a separate legal entity—assumes ownership of a business with both assets and liabilities. . . . Liabilities, alas, are often the subject of inaccurate or incomplete disclosures.

Daily v. Morgan, 701 F.2d 496, 504 (5th Cir. 1983).[31] Of course, the buyer can reduce these risks by employing

31. *See also* Exchange National Bank, 544 F.2d at 1137 ("While banks are in a favored position to obtain disclosure, the target of [the Acts] is fraud, which a bank's ability to obtain disclosure cannot always prevent."); Occidental Life Ins. Co. v. Pat Ryan & Assocs, Inc., 496 F.2d 1255, 1263 (4th Cir.) ("In one sense the large investor has a more pressing need for protection to the extent that he has expended a greater amount of his resources."), *cert. denied*, 419 U.S. 1023 (1974); Mifflin Energy Sources, Inc. v. Brooks, 501 F. Supp. 334, 336 (W.D. Pa. 1980); Titsch Printing, Inc. v. Hastings, 456 F. Supp. 445, 449 (D. Colo. 1978).

professionals to comb through the most intricate details of the seller's business. But such an investigation is costly and inefficient: the seller controls this information and is already in possession of it; and the buyer's investigation is time-consuming and expensive, thereby raising transaction costs and inhibiting the flow of capital. One of Congress' purposes in singling out the named instruments in the Act was to facilitate such transactions without the ensuing delays, duplication of effort, and expenses associated with the "caveat-stockholder" era of deregulation. *See* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 4-5 (1934). Denial of the Acts' protection in these circumstances would undermine this Congressional policy.[32]

3. *Justifiable expectations and value of the bargain*

A third concern related to the foregoing considerations is the protection of the value of the bargain to the buyer. One of the advantages to the buyer of employing stock to effectuate the sale of a business is the buyer's justifiable reliance on the antifraud provisions of the Acts to reduce transaction costs. Accordingly, the buyer may pay a price for the business that does not reflect a premium for the cost of ensuring the accuracy of all representations made. The Supreme Court has observed that such reliance by the buyer would be reasonable when the stock purchased has the traditional attributes commonly associated with stock ownership. In *United Housing Founda-*

32. Thus, we are unpersuaded by the argument that a sophisticated buyer with substantial resources is in a position to detect fraud and therefore undeserving of coverage. This argument misses the point. Of course the buyer may hire accountants and attorneys to scrutinize the seller's business; however, it is more efficient for the seller to warrant the accuracy of representations made than for the buyer to expend substantial amounts of time and money unearthing facts already known to the seller. This efficiency is one of the purposes of the Acts and promotes the marketability of securities and free flow of capital.

tion, Inc. v. Forman, 421 U.S. 837 (1975), the Court reasoned:

> There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

Id. at 850-51. In the case of stock, the Court held, those characteristics include the right to receive dividends contingent upon an apportionment of profits; negotiability; capacity for use as collateral; voting rights in proportion to the number of shares owned; and share appreciation. *Id.* at 851.

The district court concluded that the stock purchased by Ruefenacht bears these characteristics, and we accept that conclusion for the purposes of this appeal. Consequently, Ruefenacht would have been justified in agreeing on a purchase price that did not include a premium reflecting the risk of fraud. This savings to Ruefenacht represented part of the value of the bargain: and to withhold the Acts' protection in these circumstances would be to deprive the purchaser of that part of the value of the bargain.

4. *Protection of "investors"*

Congress unquestionably intended that the Act protect "investors" in the national securities markets.[33] It would, however, be a grave mistake to conclude that this single purpose exhausted Congress' intent. As we have ob-

33. For a review of some of the legislative history referring to the protection of investors in the national markets, *see Daily v. Morgan*, 701 F.2d at 500-02 n.5; *Sutter v. Groen*, 687 F.2d at 201.

served, Congress acted with a number of rationales in mind, among them the facilitation of commerce in certain named instruments to reduce transaction costs and enhance the free flow of capital. Thus, we disagree with the Seventh Circuit's view that the function of the federal Acts is limited solely to the protection of "investors," however defined. *Sutter*, 687 F.2d at 201. But even insofar as the Acts address "investors," there are flaws in the sale-of-business doctrine. The distinction between an "entrepreneur" and an "investor" is hardly obvious. Many investors may elect to participate in the management of a business in order to enhance their return on investment; indeed, in our free-enterprise system that is to be expected. Just why investors who choose to engage in entrepreneurship in order to improve the performances of their investment cease to be "investors," and become instead exclusively "entrepreneurs," is something of a mystery. It seems clear to us that these persons are both investors and entrepreneurs.[34] Even were Congress exclusively concerned with "investors" and not "entrepreneurs"—an assumption with which we strongly disagree—Ruefenacht is certainly an "investor."

Moreover, nothing suggests to us that the *Howey* test for investment accurately maps the universe of investors with which Congress might have been concerned. The *Howey* test emerged from the definition of "investment contract" under state "blue sky" laws. As used by state

34. *See* Daily v. Morgan, 701 F.2d at 503; Golden v. Garafalo, 678 F.2d at 1146 ("in truth, purchasers of a business rightly regard themselves as investors as well as managers"); Note, *Sale-of-Business Doctrine*, *supra* note 2, 83 Colum L. Rev. at 1738-39.

The Seventh Circuit acknowledges that purchasers may be both investors and entrepreneurs but assumes that investment must constitute the "purchaser's *main purpose*." *Sutter*, 687 F.2d at 203 (emphasis added). We see no evident source in the Acts for the requirement that investment must be a "main purpose" rather than a

courts and the Supreme Court, this definition was intended to supplement well-defined terms like "stock" and "note." In order to avoid sweeping into the definition of "investment contract" a vast number of joint ventures, partnerships, and other business relationships,[35] the courts confined "investment contract" to a "transaction or scheme" under which persons are led to expect profits "solely from the efforts of" others. *Howey*, 328 U.S. at 298-99. This limitation on the definition of investment contract—intended to confine the number of business relationships qualifying as securities under the acts—had no bearing whatsoever on whether instruments like "stock" were securities. Stock, bonds, notes, and debentures were well-defined instruments; there was no need to import into the definition of such instruments limitations on business relationships that might be investment contracts. Nor would there be any logic in doing so. While Ruefenacht's stock purchase may not have constituted an "investment contract"—a term of art—because of the degree of corporate control he exercised, it certainly constituted an "investment" effectuated by means of the purchase of "stock." It is erroneous to conclude that one who does not enter into an "investment contract" is *ipso facto* not an "investor." It is doubly erroneous to reason further that such an individual is therefore unprotected by the federal securities laws even

"subsidiary" purpose. Moreover, this interpretation opens a new avenue of inquiry into gradations of the purchaser's intent; we doubt that lenghty pretrial discovery and hearings on such subtleties as whether the purchaser's "main" or "subsidiary" intent was "investment" promotes the purposes of the Acts. Nor do we believe the inquiry a fruitful one: the purchaser obviously intends both to invest and to manage.

35. *See, e.g.*, Goodwin v. Elkins & Co., 730 F.2d 99, 103 (3d Cir. 1984); *id.* at 112 (Seitz, C.J., concurring); *id.* at 114 (Becker, J., concurring) (partnership agreement did not constitute an investment contract under the terms of the agreement).

though the transaction is effectuated by the purchase of an instrument clearly bearing all the attributes of stock.

5. *Arbitrary distinctions*

An additional consequence of the sale-of-business doctrine is the welter of unusual distinctions it produces among economic transactions. The sale of all of a corporation's stock to a single buyer by a single seller, for example, is alleged not to constitute the sale of a security; but the same sale to a single buyer by several sellers, each of whom did not formerly exercise control, is alleged to be a securities transaction as to the sellers but not as to the buyer.[36] Similarly, a series of stock sales each insufficient to transfer control from a single seller to a singly buyer would presumably constitute the sale of securities; a final sale leaving the buyer with stock ownership greater than 51 percent (and therefore transferring control) may or may not constitute the sale of securities, depending on how the doctrine is applied;[37] and the very same transaction consummated in a single purchase, rather than as a series of step transactions, would presumably not constitute the sale of securities.

Such distinctions are essentially arbitrary. The possibility of fraud is neither greater nor less when the purchaser acquires 49 or 51 percent of a business. Nor is the

36. McGrath v. Zenith Radio Corp., 651 F.2d 458, 467-68 n.5 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981); *see* Seldin, *supra* note 2, 37 Bus. Law. at 679-81.

37. The final sale itself arguably would not constitute the sale of a security because it transferred control to the buyer. Similarly, all prior sales amy not constitute sales of securities if they were effectively part of a single step transaction. On the other hand, it is plausible that each of the sales would constitute the sale of securities because each comprised less than 50 percent of the business. We hesitate to speculate on the proper application of the doctrine in these circumstances.

purchaser's capacity to discover fraud greater in one circumstance or the other. The variable of "control" is largely irrelevant to the risk of and capacity to discover fraud. As the Court of Appeals for the Second Circuit has observed, more appropriate considerations might include whether the sale involves a close corporation and whether the transaction takes place over a public market or face to face. *Golden v. Garafalo*, 678 F.2d at 1146. But close corporations and face-to-face transactions have always been within the compass of the acts. *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 10, 12 (1971); *see Glick v. Compagna*, 613 F.2d 31, 35 (3d Cir. 1979).

Moreover, in focusing on terms like "stock," "bond," and "note" in the early part of the definition of security, Congress drew on well-known state-law definitions. *See* Part III A 2 *supra*. These terms had a consistency of meaning under state law that did not vary with who owned the instrument at any particular moment, and did not admit of asymmetries between buyer and seller. Rather, they focused on the essential attributes of the instrument: voting rights, redemption rights, the right to participate in dividends, the right to participate in assets upon dissolution, etc. *E.g.*, 8 Del. Code Ann. § 151 (1983); 11 W. Fletcher, Cyclopedia of the Law of Private Corporations §§ 5083-5085 (1971). Fluctuations in the identity of the instrument were foreign to the notion of stock. The chameleon-like quality of stock under the sale-of-business doctrine is wholly arbitrary with respect to the state-law definitions that are the source of the terms in the 1933 and 1934 Acts.

Nor are we persuaded that economic affairs have magnified in complexity since the Seventy-Third Congress, thereby rendering these distinctions any less arbitrary. Of course, affairs of commerce are more sophisticated now than fifty years earlier; but the transaction at issue

here is not one that the appellees seek to steer clear of the securities laws because of its peculiar sophistication, and they do not argue that the transaction was unknown in earlier days. This is the simple purchase of 50 percent of a business by means of stock, a transaction as old as the concept of stock itself and certainly known to the drafters of the 1933 and 1934 Acts. If the increased sophistication of today's markets now renders appropriate a variety of distinctions that would have been rejected by the Seventy-Third Congress—an argument whose truth is hardly self-evident—we trust that Congress will amend the Acts accordingly.

6. *Adequacy of state-law protection*

Finally, it is urged that under the sale-of-business doctrine, the purchaser or seller of a business is not without a remedy for fraud; any remedy would simply lie in a common-law fraud action.[38] We do not believe that the prospect of common-law remedies changes the analysis. The premise that common-law remedies are necessarily adequate in the sale-of-business context is flawed. The defendant, for example, may prove to be insolvent, prompting the plaintiff to seek out solvent defendants among those parties who may be sued by virtue of the absence of privity requirements under federal law.[39] Congress, moreover, did not confine the protection of federal law to instances in which no adequate common-law remedy could be had. The Acts, for example, confer additional benefits on parties victimized by fraud, including the absence of express defenses and certain procedural advantages.[40] In view of the Supreme Court's

---

38. *See* Thompson, *supra* note 2, 57 N.Y.U. L. Rev. at 241-43.

39. *Cf.* Sonnehschein, *supra* note 15, 35 Bus. Law. at 1578.

40. *See generally* 1 L. Loss, *supra* note 28, at 22; 3 *id.* at 1430-34; Note, *Sale-of-Business Doctrine*, *supra* note 2, 83 Colum. L.

frequent emphasis on the remedial character of the securities Acts,[41] we do not take these proposed limitations on remedies lightly.

In summary, we do not believe that the policies underlying the Acts support the sale-of-business doctrine. To the contrary, the doctrine significantly undermines congressional policies, enhances uncertainty, and increases the likelihood of litigation. We turn now to whether recent Supreme Court authority requires a different conclusion.

B. *Recent Supreme Court Authority*

In *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), the Supreme Court held that "stock" held by a tenant in a cooperative apartment building is not a security under the federal Acts. The Court's analysis of the term "stock" admonished us to attend to substance over form:

> We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock," must be considered a security transaction simply because the statutory definition of a security includes the words "any . . . stock." Rather we adhere to the basic principle that has guided all of the Court's decisions in this area:
>
> "[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).
>
> See also *Howey*, *supra*, at 298.

Rev. at 1739 n.12, 1742; Note, *Commercial Paper*, *supra* note 15, 39 U. Chi. L. Rev. at 401 & n.264.

41. *See* Herman & MacLean v. Huddleston. _____ U.S. _____, 103 S. Ct. 683, 689-90 (1983) (availability of express remedy under § 11 of 1933 Act does not preclude action under § 10b of 1934 Act); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); *see* Lino v. City Investing Co., 487 F.2d 689, 692 (3d Cir. 1973).

421 U.S. at 848 (footnote omitted). The instruments held by the tenants, the Court concluded, lacked the attributes commonly associated with stock: the right to participate in dividends, negotiability, capacity to serve as collateral, voting rights in proportion to the number of shares owned, and appreciation in value. Consequently, the Court concluded, as a matter of economic reality the shares in issue were not "stock" within the meanings of the Acts. *Id.* at 851. As we noted earlier, the Supreme Court acknowledged that occasions may arise when the use of a particular name would lead a purchaser justifiably to assume that the federal securities laws apply, adding that "[t]his would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument." *Id.* at 850-51.

The Court then addressed whether the tenants' shares constituted an "investment contract" under the *Howey* test, concluding that they did not. *Id.* at 851-58. In the course of its investment contract analysis, the Court observed:

> In considering these [investment contract] claims we again must examine the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties. We perceive no distinction, for present purposes, between an "investment contract" and an "instrument commonly known as a 'security.' " In either case, the basic test for distinguishing the transaction from other commercial dealings is

> "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301.
>
> This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.
>
> 421 U.S. at 851-52 (footnote omitted).

The defendants now maintain that the foregoing passages direct that the *Howey* test is to be applied to all of the defined terms in the Act, including the definition of stock. We do not agree. In its discussion of stock, the Court's admonition to attend to economic reality simply instructed that the label "stock" is not dispositive if the instrument lacks the traditional elements associated with stock ownership. The Court's analysis was clearly not intended to, and did not, apply the *Howey* test to stock. Nor did the Court direct that an economic reality test be applied to stock other than to determine whether, as a matter of economic reality, the instrument was in fact "stock" as that term has historically been understood. The label of the instrument may be pierced in order to determine whether it indeed bears the indicia of stock ownership. In this case the district court has done so, holding that the "stock which Ruefenacht received contains all the attributes mentioned by the *Forman* Court as indicating that the transaction did involve a security." App. at 220.

In the second portion of the *Forman* Court's analysis—addressing the definition of "investment contract"—the Court's reference to economic reality prefaced the

application of the *Howey* test. That analysis was entirely proper: the *Howey* test has for some 40 years been the appropriate metric for gauging whether, as a matter of economic reality, a business relationship constitutes an "investment contract." In no sense was the Court instructing that the *Howey* test also be applied to stock. Had the Court intended that result, of course, it would have done so. Nor was the Court holding that the same economic reality test applies to the definitions of "stock" and "investment contract." To the contrary, in assessing the economic reality of a stock transaction, we pierce the label and look to the underlying attributes of the instrument. In evaluating an investment contract, we apply the *Howey* test. Thus, *Forman* undermines rather than supports the defendants' position.

Subsequent Supreme Court authority is also unavailing. In *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1981), the Court held that a noncontributory, compulsory pension plan was not an investment contract. In part the Court reasoned that ERISA supplanted any necessity for coverage by the securities Acts. 439 U.S. at 569-70. The Court expanded on this theme in *Marine Bank v. Weaver*, 455 U.S. 551 (1982), holding that a certificate of deposit insured by the FDIC did not constitute a security. Again the Court reasoned that the FDIC supplanted any necessity for coverage under the securities laws. 455 U.S. at 558. No such regulatory schemes apply in the sale-of-business context. Nor does the language in those opinions speak in favor of applying the investment-contract test to stock. Indeed, the Court's analysis in *Weaver* paralleled that of *Forman*: the Court first ascertained that a certificate of deposit is not a "note" or "withdrawable capital share," and only then turned to whether the separate agreement was an "investment contract" under the *Howey* test. 455 U.S. at 556-60. *Weaver* therefore reinforces our interpretation of *Forman*.

VI. Conclusion

We reject the sale-of-business doctrine as applied to sales of stock. The structure and history of the Acts—particularly Congress' express treatment of short-term notes and its conferral of exemption power on the SEC—counsel against such application. In addition, the doctrine is inconsistent with several policies underlying the Acts: it exacerbates uncertainty; undermines a congressional policy protecting certain instruments in order to reduce transaction costs and facilitate commerce; denies protection to investors simply because those persons are also "entrepreneurs"; deprives purchasers and sellers of part of the value of the bargain; and introduces arbitrary distinctions in the application of the definition of "security." Moreover, the doctrine derives from a misreading of *United Housing Foundation, Inc. v. Forman, supra. Forman* instructed that we attend to economic reality, in this case whether, as a matter of economic reality, the instrument has the attributes commonly associated with stock; *Forman* did not direct the application of the *Howey* test to stock. Finally, the doctrine originated as a limitation on the breadth of the word "note." While the *Howey* standard might have been an imperfect expedient in the note area—a subject on which we express no opinion—a similar limitation on stock is unnecessary. Stock is a well-defined term, is not issued by consumers, and is not employed by business to finance current operational costs.

Thus, we hold that the sale of all or part of a business effectuated by the transfer of stock bearing the traditional incidents of stock ownership is the sale of a "security" under the 1933 and 1934 Acts. The judgment of the district court will be reversed and the case remanded for further proceedings consistent with this opinion.

HUNTER, *Circuit Judge*, Concurring:

1. I concur in the majority's conclusion that plaintiff Max A. Ruefenacht ("Ruefenacht") purchased "securities" within the meaning of the Securities act and Securities Exchange Act when he purchased fifty percent of the shares of Continental Import & Export, Inc. ("Continental") in the form of instruments bearing the name and all the traditional attributes of stock. I note, however, that this court, in *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973), accorded the "context clause" of the federal securities acts a broader meaning than does the majority in this case. *Compare id.* at 694-95, *with* the majority opinion *supra*, typescript at 30-35.

2. Following *Lino*, I reach the same conclusion as the majority regarding the particular transaction at issue here. The court below found that Ruefenacht acquired no more than joint control over Continental, that Ruefenacht and Birkle exercised absolute veto power over each other in all important business matters, and that Ruefenacht continued to be a full-time employee of Autobern Trading Co., Inc. "The commercial context of this case," *see Lino*, 487 F.2d at 685, persuades me to conclude that the district court erred in dismissing Ruefenacht's claims for lack of federal jurisdiction under the securities acts. Accordingly, I join the majority in ordering a remand.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

CIVIL ACTION NO. 80-1097

MAX A. RUEFENAUCHT,
Plaintiff,
CHRISTOPHER J. O'HALLORAN,
JOACHIM K. BIRKLE and
CONTINENTAL IMPORT & EXPORT INC.,
Defendants,
and
CHRISTOPHER J. O'HALLORAN,
Third-Party Plaintiff,
vs.
W. GEORGE GOULD,
Third-Party Defendant.

OPINION AND JUDGMENT OF JUDGE SAROKIN

Newark, New Jersey
April 15, 1983

BEFORE:
HON. H. LEE SAROKIN, U.S.D.J.

(2) THE COURT: This matter comes before the court on a renewal of a summary judgment motion made by defendant W. George Gould. The facts of the case are summarized in this court's previous opinion on this motion; *Ruefenacht v. O'Halloran*, No. 80-4097 (D.N.J. April 21, 1982). Defendant Gould then moved for summary judgment dismissing the complaint for lack of federal jurisdiction.[1] Federal jurisdiction is based upon the federal securities laws. Defendant asserts that the transactions that are the basis of this suit did not involve "securities" as defined in the federal securities laws. Defendant moves to dismiss the federal claims for lack of jurisdiction and to dismiss the pendent state law claims as a matter of discretion.

In its previous opinion the court discussed a controversial point of law that has divided the federal courts of appeal. Briefly stated, the question is whether a transaction involving ordinary stock is necessarily a security transaction under the federal laws. The definitions of "security" in the federal statutes literally include "stock", but they also contain the words, "unless the context otherwise requires." 15 U.S.C. Section 77b; 15 U.S.C. Section 78c(a)(10). The Supreme Court and lower courts have applied an "economic reality" test[2] to determine whether transactions involve "securities" within the meaning (3) of the federal statutes,[3] but the Supreme Court has never applied this test to a transaction involving ordinary stock. Several circuit courts of appeal have

1. The other defendants in the case joined in the motion.

2. "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *S.E.C. v. Howey Co.*, 328 U.S. 293, 301(1946).

3. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837(1975); *S.E.C. v. Howey Co.*, 328 U.S. 293(1946); *Marine Bank v. Weaver*, _____U.S. _____, 102 S.Ct. 1220(1982).

applied this test to ordinary stock transactions. *Frederiksen v. Poloway*, 637 F.2d 1147(7th Cir.), *cert. denied*, 451 U.S. 1017(1981); *Sutter v. Groen*, 687 F.2d 197(7th Cir.1982); *King v. Winkler*, 673 F.2d 342(11the Cir. 1982); Chandler v. Hew, Inc. 691 F.2d 443 (10th Cir. 1977). Two circuit courts of appeal have refused to apply the "economic reality" test to transactions involving ordinary stock, concluding that these transactions are literally within the definitions of "security". *Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202(4th Cir.1979), *cert. denied*, 444 U.S. 868(1979), *Golden v. Garofalo*, 678 F.2d 1139(2d Cir. 1982); *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227(2d Cir. 1982). The Third Circuit Court of Appeals has not yet ruled on this precise question.[4]

The court, in its previous opinion, determined that the "economic reality" test should be applied to transactions involving conventional stock to determine if they are entitled to the protection of the federal securities laws. The court characterized the crucial issue as "the amount of control" that plaintiff gained over the business whose stock was purchased (Continental Import & Export, Inc.). Slip. op. at 9. The court referred the matter to the Magistrate for a (4) hearing, and denied the motion for

4. The court in *Golden* cited *Glick v. Campagna*, 613 F.2d 31 (3d Cir. 1979) as support for its position, at 678 F.2d 1142n.4. In *Glick* the court discussed the merits of regulating close corporations. 613 F.2d at 35n.3. This court has reviewed that decision and concludes that the court of appeals did not determine the precise question presented here. *Goodman v. DeAzoulay*, 554 F.Supp. 1029, 1034(E.D.Pa.1983). Several other district courts in this circuit have applied the economic reality test to transactions involving stock since *Glick*. *Anchor-Darling Industries, Inc. v. Suozzo*, 510 F.Supp. 659(E.D.Pa.1981); *Somogyi v. Butler*, 518 F.Supp. 970(D.N.J.1981); *Pallastrine v. Blimpie Industries, Ltd.*, No. 79-3328(E.D.Pa. Dec. 9, 1981).

summary judgment without prejudice to the right to renew upon completion of the hearing.

The court has received a Report and Recommendation from the Magistrate with detailed findings about the extent of control to be exercised by Mr. Ruefenacht in the business of Continental. Based on these findings, defendant Gould has renewed his motion for summary judgment.

The court has received objections to the Report and Recommendation from David Bernstein, a third-party defendant. Mr. Bernstein objects to the finding that Ruefenacht's "company is one of the third-party defendants, Autobern Trading Co., Inc., *in which Ruefenacht is associated with another third-party defendant, David Bernstein*" (emphasis added). Mr. Bernstein asserts that he was no longer associated with Mr. Ruefenacht or Autobern Trading Co., Inc., except as a shareholder in redemption, at the time of the transactions involved in this case. In addition, Mr. Bernstein objects to the findings that he was a continuing business partner in Autobern, and that he was to be paid five hundred dollars per week to handle the books and records of Continental. The court concludes that these findings are not necessary to a determination of the jurisdictional issue before it. Having received no opposition to their deletion (5) from any other party, the Court will adopt the Report and Recommendation without these findings as to Mr. Bernstein.

The conclusion of the Magistrate regarding the extent of control to be exercised by Mr. Reufenacht is as follows.

> Based upon the foregoing findings of fact it is concluded that Ruefenacht intended to purchase a 50% ownership of the shares of stock of Continental and to exercise all that control to which a 50% owner is

entitled. It has not been shown that there was any possible way that Ruefenacht could have exerted more control. His actions were at all times subject to the absolute veto of his partner, Mr. Birkle. The actions of the parties are consistent with equality of control and joint participation in the business of the corporation is clearly demonstrated by the evidence presented. There is no evidence to the contrary.

At oral argument on this renewed motion counsel for plaintiff once again urged the court to adopt the position that the "economic reality" test does not apply to transactions involving ordinary stock. The court has considered the arguments of counsel and the legal developments that have occurred since its original decision and concludes that its previous decision to the contrary should remain. The "economic reality" test should be applied to transactions (6) involving ordinary stock to determine whether they involve securities within the meaning of the federal securities acts.

In applying this test to the facts of this case the crucial question is whether the profits were to come "solely from the efforts of others." The other parts of the test are satisfied here, for the transaction involved investment in a common enterprise with an expectation of profits. The findings of the Magistrate indicate that Mr. Ruefenacht intended to exercise joint control of the business with Mr. Birkle; there would be "equality of control." Based on these findings the court concludes that the profits of the enterprise would not be derived "solely" or substantially from the efforts of others. Therefore, the transaction does not involve "securities" within the meaning of the federal securities acts.

The key to the application of the "economic reality" test to this case is that plaintiff was an active investor who intended to participate significantly in the management of the business. He was not a passive investor who relied on others to manage the business. "Not all sales transactions which involve 'stock' are necessarily covered by the securities laws. Rather, the test for coverage, in general is whether the purchaser is placing money in the hands of another who will control the funds and the business (7) decisions." *Frederiksen*, 637 F.2d at 1148. The court in *Sutter v. Groen*, 687 F.2d 197(7th Cir. 1982), characterized this distinction as one between investors, who "rent capital to those who want to manage", and entrepeneurs, who "buy assets to manage." *Id.* at 202. Plaintiff here was acting as an entrepeneur, with an intent to jointly manage the business, rather than as a passive investor, who rented his capital to others who managed the business.

Although many of the cases relied upon by defendant involve a sale of virtually one hundred percent of a corporation's securities and assumption of complete control of the business,[5] the amount of the stock purchased is not the determining factor. The more important factor is how much control the plaintiff intended to exercise over his investment. "It is apparent that the approach used here is not a function of numbers. A sale of less than 100% of the stock might not be covered by the Acts. A sale of 100% of the stock can be covered by the Acts." *King*, 673 F.2d at 346. In *Goodman*, 554 F.Supp. 1029, the court found that the purchaser of one-third of the stock of a corporation did not purchase "securities" within the meaning of the federal securities acts. The evidence indicated that the purchaser had "active control of her investment." *Id.* at 1035. The Seventh Circuit Court of Appeals has created a rebuttable presumption

5. *Frederiksen v. Poloway*, supra; *King v. Winkler*, supra; *Chandler v. Kew, Inc.*, supra; *Anchor-Darling Industries, Inc. v. Suozzo*, supra; *Somogyi v. Butler*, supra.

(8) to be used in cases where a large block of stock, but not 100%, has been purchased. *Sutter v. Groen*, 687 F.2d at 203. If the purchaser acquires more than fifty percent of the common stock of the corporation "his purpose in purchasing the stock will be presumed to have been entrepeneurship rather than investment." *Id.*[6] In *Pallastrone v. Blimpie Industries, Ltd.*, No. 79-3328(E.D.Pa. Dec. 9, 1981), the court found that purchasers of fifty percent of a company's stock had not purchased "securities." The court found that the "plaintiffs entered into the agreement with Figueroa for the purpose of purchasing a one-half interest in a business which they intended to operate and manage in conjunction with the defendant Figueroa . . ." Slip op. at 7.

The trend of the law is to apply the "economic reality" test to purchases of less than all of the company's stock to determine whether the purchaser would actively manage his investment. Because Mr. Reufenacht intended to jointly manage Continental with Mr. Birkle, he did not purchase "securities" as defined in the federal acts. Therefore, there is no jurisdiction to support the federal securities claims in the complaint. These claims are dismissed for lack of jurisdiction. There is no diversity of citizenship among the parties to support the pendent state law claims independently of the asserted basis for federal (9) jurisdiction. The court, in its discretion, will dismiss these claims as well. *United Mine Workers v. Gibbs*, 383 U.S. 715 (1966).

---

6. The court specifically did not consider the application of these principles to a purchase of fifty percent or less of a company's stock. *Id.*

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

HON. H. LEE SAROKIN

CIVIL ACTION NO. 80-4097

MAX A. RUEFENACHT,
Plaintiff,

v.

CHRISTOPHER J. O'HALLORAN,
JOACHIM K. BIRKLE,
CONTINENTAL IMPORT & EXPORT, INC.,
and W. GEORGE GOULD,
Defendants,

and

W. GEORGE GOULD,
Third-Party Plaintiff,

v.

DAVID BERNSTEIN, AUTOBERN TRADING
CO., INC., ERNEST STOECKLIN,
LENZENHOF GMBH,
Third-Party Defendants.

ORDER GRANTING SUMMARY JUDGMENT DISMISSING PLAINTIFF'S COMPLAINT

This matter being opened to the Court by Hannoch, Weisman, Stern, Besser, Berkowitz & Kinney, P.A., attorneys for defendant, W. George Gould, for an entry of

an Order for summary judgment dismissing plaintiff's complaint; and the Court having considered the parties' papers, pleadings, briefs and affidavits, and for good cause shown;

IT IS on this 16 day of May, 1983,

ORDERED that plaintiff Max A. Ruefenacht's complaint be and hereby is dismissed with prejudice.

/s/ H. Lee Sarokin
H. LEE SAROKIN, U.S.D.J.

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

HON. H. LEE SAROKIN

MAX A. RUEFENACHT,
Plaintiff,

CHRISTOPHER J. O'HALLORAN, et al.,
Defendants,

and

CHRISTOPHER J. O'HALLORAN,
Third-Party Plaintiff,

vs.

W. GEORGE GOULD,
Third-Party Defendant.

CIVIL ACTION NO. 80-1097

AMENDED ORDER GRANTING SUMMARY JUDGMENT DISMISSING PLAINTIFF'S COMPLAINT

COHN & LIFLAND, ESQS.
Attorneys for Plaintiff
Park 80 Plaza West One
Saddle Brook, N.J. 07662-5865

Heard: May 12, 1983

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

HON. H. LEE SAROKIN

CIVIL ACTION NO. 80-4097

MAX A. RUEFENACHT,
Plaintiff,

CHRISTOPHER J. O'HALLORAN, et al.,
Defendants,

and

CHRISTOPHER J. O'HALLORAN,
Third-Party Plaintiff,

vs.

W. GEORGE GOULD,
Third-Party Defendant.

AMENDED ORDER GRANTING SUMMARY JUDGMENT DISMISSING PLAINTIFF'S COMPLAINT

This matter being opened to the Court by HANNOCH, WEISMAN, STERN, BESSER, BERKOWITZ & KINNEY, P.C., attorneys for third-party defendant, W. George Gould, for entry of an Order for summary judgment dismissing plaintiff's complaint for lack of subject matter jurisdiction and all defendants not in default having joined therein; and the Court having considered the parties' papers, pleadings, briefs and affidavits, and for good cause shown;

It is on this 27 day of June, 1983;

ORDERED, that judgment be entered in favor of all defendants and against the plaintiff dismissing this action for lack of subject matter jurisdiction.

/s/ H. Lee Sarokin
H. LEE SAROKIN, U.S.D.J.

APPENDIX C

UNITED STATES CODE
TITLE 15

§ 77l. Civil liabilities arising in connection with prospectuses and communications

Any person who—

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

May 27, 1933, c. 38, Title I, § 12, 48 Stat. 84; Aug. 10, 1954, c. 667, Title I, § 9, 68 Stat. # 686.

APPENDIX D

UNITED STATES CODE
TITLE 15

§ 77q. Fraudulent interstate transactions

Use of interstate commerce for purpose of fraud or deceit

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce of by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Use of interstate commerce for purpose of offering for sale

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such

security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

Exemption of section 77c not applicable to this section

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

May 27, 1933, c. 38, Title I, § 17, 48 Stat. 84; Aug. 10, 1954, c. 667, Title I, § 10, 68 Stat. 686.

APPENDIX E

UNITED STATES CODE
TITLE 15

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

June 6, 1934, c. 404, Title I, § 10, 48 Stat. 891.

APPENDIX F

CODE OF FEDERAL REGULATIONS
12 CFR

§ 240.10b-5. Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

No. 84-165

In The

Supreme Court of the United States

October Term, 1984

W. GEORGE GOULD,

Petitioner,

vs.

MAX A. RUEFENACHT, et al.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF IN OPPOSITION

PETER S. PEARLMAN
Park 80 Plaza West One
Saddle Brook, New Jersey 07662

Counsel for Respondent
Max A. Ruefenacht

PETER S. PEARLMAN
JEFFREY W. HERRMANN
COHN & LIFLAND, ESQS.
Park 80 Plaza West One
Saddle Brook, New Jersey 07662
(201) 845-9600

Of Counsel

COCKLE LAW BRIEF PRINTING CO., (800) 835-7427 Ext. 333

QUESTION PRESENTED

Did the Court of Appeals correctly hold that the purchase of fifty percent of the shares of stock of a closely held corporation by one who participates in the affairs of the corporation is the purchase of "securities" within the meaning of the federal securities laws?

TABLE OF CONTENTS

TABLE OF CASES

CASES CITED—Continued

STATUTES CITED

No. 84-165

—o—

In The

Supreme Court of the United States

October Term, 1984

—o—

W. GEORGE GOULD,

Petitioner,

vs.

MAX A. RUEFENACHT, et al.,

Respondents.

—o—

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

—o—

BRIEF IN OPPOSITION

—o—

STATEMENT OF THE CASE

In the summer of 1980 plaintiff-respondent, Max A. Ruefenacht (Ruefenacht), purchased fifty percent of the issued and outstanding shares of common stock of Continental Import and Export, Inc. (Continental) an importer and distributor of wines and spirits.

The other fifty percent was held by defendant, Joachim Birkle (Birkle), Birkle's wife and a corporation known

as Lenzenhof GmbH whose affairs were controlled by Birkle. An an incentive to entice Ruefenacht to purchase the shares, certain financial statements, prospectuses and pro forma balance sheets were given to him. Ruefenacht contends that the representations as to Continental's financial status contained in those documents contained material misrepresentations of fact and omitted to state material facts necessary to make the facts contained therein not misleading. Ruefenacht contends that he purchased the shares in reliance upon the misrepresentations and with ignorance of the omissions.

Although Ruefenacht did perform certain limited services on behalf of Continental, he never intended to and, in fact, never did participate in the daily management of its business affairs. On the contrary, at all times, Ruefenacht was a full time employee of another corporation in a different line of business. Ruefenacht never attempted or intended to exercise any control over the day-to-day affairs of Continental nor could he. The only control which he maintained was that degree of control to which any fifty percent shareholder would be entitled by law.

After he had paid $120,000 on account of the $250,000 purchase price Ruefenacht learned of the false nature of the representations made and the omissions and sought to rescind the transaction and obtain return of his money which request was refused. Upon that refusal, Ruefenacht instituted this action against Birkle, Continental, Christopher O'Halloran, the certified public accountant who prepared the financial statements and W. George Gould, the petitioner herein (Gould). Gould was both

Continental's corporate counsel and a member of its Board of Directors in which capacity he both approved and prepared the directors' resolutions containing the allegedly false financial data which he then submitted to O'Halloran. Ruefenacht alleged violations of Sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. § 77(1) (2), Section 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), Rule 10(b) (5) of the Securities and Exchange Commission, 17 C.F.R. 240.10(b) (5) as well as certain state law claims.

Gould moved for summary judgment seeking to dismiss the federal securities law claims on the grounds that the shares of stock purchased by Ruefenacht were not "securities" within the definition of the federal securities laws. The motion further sought to dismiss the pendent state law claims based upon lack of federal jurisdiction. Relying on the theory of law known as the "Sale of Business doctrine"* Gould contended that Rue-

---

*The concept of the "sale of business doctrine" has been adopted by several circuits. One of the less attractive aspects of that doctrine seems to be that the precise definition tends to vary from court to court. More or less, it seems to provide that where one acquires control (the nature of which is never clear) over a corporation through the purchase of all or substantially all of its stock, (how much is subject to debate) the purchaser (as opposed to the Seller?) should not be entitled to the protection of the federal securities laws because the acquisition of the stock is merely a means to purchase the business itself. See, *Landreth Timber Co. v. Landreth,* [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,705 at 97,827 (9th Cir. March 7, 1984), *petition for cert. filed,* 52 U.S.L.W. 3908 (U.S. May 31, 1984) (No. 83-1961); *Christy v. Cambron,* 710 F.2d 669, 672 (10th Cir. 1983); *Sutter v. Groen,* 687 F.2d 197, 199-204 (7th Cir. 1982); *King v. Winkler,* 673 F.2d 342, 344-46 (11th Cir. 1982).

fenacht participated in the company's affairs to such an extent and acquired such significant control over Continental's business that his stock purchase was not an investment made with the expectation that profits would come solely from the efforts of others.

After an evidentiary hearing on the issue of the extent to which Ruefenacht intended to acquire control over Continental, the trial court concluded:

> "The trend of the law is to apply the 'economic reality' test to purchases of less than all of the company's stock to determine whether the purchaser would actively manage his investment. Because Mr. Ruefenacht intended to jointly manage Continental with Mr. Birkle, he did not purchase 'securities' as defined in the federal acts."

Ruefenacht v. O'Halloran, et al., No. 80-4097 (D. N.J. April 15, 1983).*

On the strength of that conclusion the trial court granted summary judgment dismissing the securities law claims. In its discretion the court dismissed the pendent state law claims as well.

On Ruefenacht's appeal, the Third Circuit reversed, holding that it is neither necessary nor appropriate for the court to examine the economic realities of the purchase or sale of all or part of the business effectuated by the transfer of stock bearing the traditional incidents of stock ownership concluding that:

> "The sale of all or part of the business effectuated by the transfer of stock bearing the traditional incidents of stock ownership is the sale of a 'security' under the 1933 and 1934 Acts."

Ruefenacht v. O'Halloran, 737 F.2d 320 (3d Cir. 1984).

---

*Unreported but reproduced in Appendix B of the Petition for Writ of *Certiorari* filed herein at p. 44a.

ARGUMENT

POINT I

There Is No Case Presently Pending Before This Court Which Will Permit The Court, In Conjunction With This Case To Delimit The Definition Of "Security" Under Federal Law As Suggested By Petitioner.

Petitioner has suggested that because of the grant of *certiorari* in *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227 (2d Cir. 1982), *modified*, 710 F.2d 95 (1983), *cert. granted*, 52 U.S.L.W. 3185 (1984) *(Seagrave)* this Court should grant *certiorari* in this matter to add "two important factual dimensions not present in *Seagrave*." In thus attempting to bootstrap himself into the Supreme Court, petitioner suggests that he should be here by virtue of the pendency of *Seagrave*. Since the filing of Mr. Gould's Petition, however, *Seagrave* has been dismissed and is no longer pending before this Court. Accordingly, there is nothing to which to append the instant case.

Respondent is aware, however, that a Petition for a Writ of *Certiorari* has been filed in *Landreth Timber Co. v. Landreth*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,705 (9th Cir. March 7, 1984), *petition for cert. filed*, 52 U.S.L.W. 3908 (U.S. May 31, 1984) (No. 83-1961) *(Landreth)*. While not conceding that a grant of *certiorari* would be appropriate in *Landreth*, if the Court were to grant *certiorari* to petitioner in *Landreth* two important considerations impel Mr. Ruefenacht to suggest that a grant of *certiorri* also would be appropriate here.

Preliminarily, respondent wishes to be clear in his position that the sale of business doctrine is entirely base-

less and has no place in the federal securities laws. Nonetheless, if the Supreme Court considers the issue of the sale of business doctrine important enough to review, the *Ruefenacht* action does provide a vehicle for the Court to decide whether that doctrine should exist at all and, if so, to provide guidance on its parameters. The instant case does provide a unique opportunity because it involves both a purchase of fifty percent of the outstanding shares (neither a majority nor a minority) and an individual who did participate, to some extent, in the affairs of the business, without devoting his entire strength, time and energy to it.

Further, a decision in *Landreth* acknowledging the existence of the sale of business doctrine without any decision in this case would leave Mr. Ruefenacht very much up in the air on how that doctrine would apply to him. The trial court here established its own view of what the sale of business doctrine is. One of the severest failings of that doctrine is that each court which has advanced it has done so in a different way and with different parameters. In the event that this Court should accept that doctrine it may or may not adhere to the trial court's ruling here that for the purchase of stock to be a security, the profits of the venture must be derived "solely" from the efforts of others.

Obviously, in the event that the Court were to reject the sale of the business doctrine, as Mr. Ruefenacht believes it must, there would be no reason to decide this case at all inasmuch as the rejection of the sale of business doctrine automatically would affirm the decision of the Third Circuit.

POINT II

The Third Circuit's Ruling Is In Absolute Conformity With The Holdings Of The Supreme Court In Forman And Weaver.

Petitioner argues that the *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837 (1975) requires that the Court apply the "economic reality test" (as they perceive it to have been applied in *Forman)* in each transaction where federal securities laws are invoked, in order to determine whether the instrument in question is, in fact, a "security". Petitioner contends that *Forman* rejected what he refers to as the "literal approach" to the definition of a security and that this Court established a rule which requires a court to evaluate the "economic realities" of each transaction alleged to involve a security in order to determine whether or not, within the context of that transaction, the plaintiff met the "economic reality" test first enunciated by this Court in *S.E.C. v. W. J. Howey Co.,* 328 U.S. 293 (1946) *(Howey).* Petitioner contends that this test must be applied whether or not the instrument was one of those specifically enumerated as a security in the statute such as "stock".

Petitioner contends further that the Third Circuit's ruling conflicts with his view of the holding in *Forman* and *Marine Bank v. Weaver,* 455 U.S. 551 (1982) *(Weaver).*

Indeed, the Third Circuit's opinion in *Ruefenacht* does conflict with petitioner's reading of both *Forman* and *Weaver;* the decision is in complete accordance with the decisions in *Forman* and *Weaver* themselves, however.

In *Forman* this Court determined that an instrument referred to as "stock" held by a tenant in a cooperative apartment building was not a security under the federal securities laws. The Court first examined the instrument to determine whether *in reality* that instrument was stock. It is this examination as to whether the instrument itself really was stock that seems to have confused petitioner. The Court observed:

> "We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called 'stock', must be considered a security transaction simply because the statutory definition of a security includes the words 'any . . . stock.' Rather we adhere to the basic principle that has guided all of the court's decisions in this area:
>
> "'[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality.' Tcherepnin v. Knight, 389 U.S. 332-336 (1967)." 421 U.S. at 848.

The reference to economic reality referred to in the first part of the *Forman* decision was simply a reference to the character of the instrument itself and not the nature of the transaction as petitioner mistakenly contends. The instruments held by the tenants, the court concluded, lacked the attributes commonly associated with stock: the right to participate in dividends, negotiability, capacity to serve as collateral, voting rights in proportion to the number of shares owned, and appreciation in value. Consequently, the court concluded, as a matter of economic reality the shares in issue were not "stock" within the meaning of the securities acts. *Forman* at 848.

This Court further noted that occasions may arise when the use of a particular name would lead a purchaser justifiably to assume that the federal securities laws would apply observing that:

> "[t]his would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument." *Forman* at 850-851.

Having determined that the instrument in question was not really "stock" and therefore not automatically a security, this Court went on to determine whether the instrument still might qualify as a security under another part of the definition, in that case, as an "investment contract". It was in order to determine whether or not the tenant's "shares" constituted an investment contract that the court applied the *Howey* test and concluded that they did not, *Forman* at 851-858. In the course of its investment contract analysis the Court observed:

> "In considering these [the investment contract] claims we must again examine the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties. We perceive no distinction, for the present purposes, between an 'investment contract' and an 'instrument commonly known as a "security".' In either case, the basic test for distinguishing the transaction from other commercial dealings is 'whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.' *Howey,* 328 U.S. at 301." 421 U.S. at 851-852.

At no time did this Court suggest that the *Howey* test was to be applied to an instrument containing the attributes of traditional stock. Had this Court intended to do that it would have. Nor did this Court hold that the

same economic realities test applies to the definition of "stock" and "investment contract". To the contrary, in assessing the economic realities of a stock transaction the Court pierced the label to look to the underlying attributes of the instrument. In evaluating whether a transaction involved an investment contract it applied the *Howey* test.

Petitioner goes on to contend that the recent holding of this Court in *Weaver* supports their position and that the Third Circuit has misinterpreted *Weaver* as well. Once again, petitioner misreads the relevant authority. In holding that a certificate of deposit insured by the F.D.I.C. did not constitute a security, the Court reasoned, in part, that the F.D.I.C. has supplanted any necessity for coverage under the securities laws. 455 U.S. at 558. In doing so it adopted a theme expressed by it in *International Brotherhood of Teamsters v. Daniels,* 439 U.S. 551 (1981) where the court held that a noncontributory, compulsory pension plan was not an investment contract in part because ERISA supplanted any necessity for coverage by the securities acts 439 U.S. at 569-570.

Nor does the language of *Weaver* suggest that the *Howey* test should be applied to determine whether an instrument which falls within the strict definition of a security is in fact entitled to coverage under the federal securities laws. In *Weaver,* the plaintiffs had contended that the certificate of deposit was a "security" or, alternatively, that the private agreement between the plaintiffs and the borrowers was a "security". In arriving at its decision that no security was involved, this Court followed the same two step test that it enunciated in *Forman.* First,

it examined the statutory definition of a security and observed that while the term "certificate of deposit" was not found therein, there were other instruments to which the certificate of deposit might be equivalent. The Court observed, of course, that if the certificate of deposit was the equivalent of any of the specifically named instruments, it would automatically qualify as a security. 455 U.S. at 557-558. The Court found that it was not.

Having concluded that the certificate of deposit could not be equated with any of the specifically enumerated items which would automatically qualify it for treatment as a security, this Court applied the second part of the same two part test which it applied in *Forman* to determine whether the agreement between plaintiffs and the borrowers might be a "certificate of interest or participation in a profit sharing agreement" or an "investment contract". 455 U.S. at 559. Here, for the first time, the Court applied the *Howey* test and found, that based on that test, that the particular agreement did not fall within the definition of either an investment contract or a profit sharing agreement and accordingly could not qualify as a security under those definitions either. 455 U.S. 556-560. Accordingly, *Weaver* reinforces the position of the Third Circuit and not that taken by petitioner.

—o—

CONCLUSION

For the foregoing reasons, respondent respectfully prays that unless the Court determines to grant *certiorari* in *Landreth* or some other case in which it will determine

the existence (or, preferably, lack thereof) of the sale of business doctrine, the Petition for a Writ of *Certiorari* should be denied for the reasons expressed above; in the event *certiorari* is granted in Landreth or some other case involving the same issue, respondent concedes that a grant *certiorari* would be appropriate in this case.

Respectfully submitted,

PETER S. PEARLMAN
Park 80 Plaza West One
Saddle Brook, New Jersey 07662

Counsel for Respondent
Max A. Ruefenacht

Peter S. Pearlman
Jeffrey W. Herrmann
Cohn & Lifland, Esqs.
Park 80 Plaza West One
Saddle Brook, New Jersey 07662
(201) 845-9600

Of Counsel

Dated: October 16, 1984

(3)

No. 84-165

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

W. GEORGE GOULD,

Petitioner,

v.

MAX A. RUEFENACHT,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF FOR PETITIONER

ROBERT C. EPSTEIN
Counsel of Record for Petitioner
W. George Gould
HANNOCH, WEISMAN, STERN, BESSER,
BERKOWITZ & KINNEY, P.A.
744 Broad Street
Newark, New Jersey 07102
(201) 621-8800

On the Brief
ROBERT C. EPSTEIN
DEAN A. GAVER
JOSEPH J. FLEISCHMAN
ELLEN B. KULKA
MICHAEL A. O'CONNOR

QUESTION PRESENTED

Is the purchaser of half of a business, who obtains absolute veto power over all major business decisions, intends to share all top level decisions of the firm, and actively participates in the company's affairs, entitled to federal securities law protection simply because the transaction was structured as a stock purchase?

LIST OF PARTIES TO THE PROCEEDINGS IN THE COURT OF APPEALS

Appellant

MAX A. RUEFENACHT

Appellees

W. GEORGE GOULD
CHRISTOPHER J. O'HALLORAN
DAVID BERNSTEIN

TABLE OF CONTENTS

Table of Contents (Continued)

TABLE OF AUTHORITIES

Table of Authorities (Continued)

Table of Authorities (Continued)

In The

Supreme Court of the United States

OCTOBER TERM, 1984

No. 84-165

W. GEORGE GOULD,

Petitioner,

VS.

MAX A. RUEFENACHT,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

---

BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the District Court for the District of New Jersey, dated April 21, 1982, (J.A. 45a-50a), denying defendants' motion for summary judgment without prejudice and referring the matter to the Magistrate for a hearing, is not reported. The report and recommendation of the Magistrate, dated January 31, 1983, is reproduced at J.A. 51a-56a. The opinion of the District Court for the District of New Jersey, dated April 15, 1983 (J.A. 57a-62a), dismissing the complaint, is not reported. The opinion of the Court of Appeals, entered

June 11, 1983 (Pet. App. A, 2a-43a), reversing the judgment of dismissal is reported at 737 F.2d 320 (3rd Cir. 1984).

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was entered on June 11, 1984 (Pet. App. A, 2a-43a). A petition for a writ of certiorari was timely filed on July 27, 1984 and was granted on November 13, 1984.

STATUTORY PROVISIONS INVOLVED

The statutory provisions involved are those sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 that define the term "security." The definition contained in the Securities Act of 1933 is as follows:

> When used in this subchapter, *unless the context otherwise requires*—
>
> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contact, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including an interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1)(1982) (emphasis added).

The definition of "security" contained in the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10) (1982), is, for present purposes, essentially identical. In each instance, the definition is preceded by the phrase "unless the context otherwise requires." The Securities Act of 1933 and the Securities Exchange Act of 1934 will hereafter be referred to collectively as the "securities laws."

Other statutory provisions involved herein are sections 12 and 17 of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934, including Securities and Exchange Commission Rule 10b-5 promulgated thereunder. These provisions are reproduced at Pet. Apps. C through E.

STATEMENT OF THE CASE

A. Circumstances of the Transaction

In June, 1980 plaintiff-respondent Max A. Ruefenacht ("Ruefenacht") purchased 2500 newly-issued shares of the common stock of Continental Import and Export, Inc. ("Continental"), an importer and distributer of wines and spirits. As a result of the purchase, Ruefenacht owned 50% of the company's outstanding shares (J.A. 52a).

The agreed-upon purchase price was $250,000, a sum which reflected a "discount" to Ruefenacht in return for his agreement to actively participate in Continental's business (J.A. 46a). In addition, in connection with the stock purchase Ruefenacht acquired multifaceted control over the company's affairs, and in fact actively participated therein, to wit: (1) he acquired the right to veto all major company decisions, both structural and operational, including stock issuance, liquidation, obtaining new product lines and borrowing funds (J.A. 53a, 56a); (2) he was to become chairman of the board of directors and receive a salary of $24,000 annually (J.A. 53a); (3) he was extensively involved in numerous regular meetings with suppliers, and solicited contracts to import beverages on behalf of the firm (J.A. 54a-55a); (4) he actively participated in the company's sales and marketing efforts, in connection with

which he applied for and received a state liquor license (or solicitor's permit), representing therein that he would sell alcoholic beverages to wholesalers and receive in return a salary and compensation for expenses (J.A. 47a); (5) he became a signatory for Continental's checks, and to do so denominated himself as the company's vice-president and treasurer (J.A. 46a-47a,53a); (6) he substantially influenced or directed the hiring of key personnel (J.A. 53a-54a); and (7) he issued directions to Continental's counsel regarding securing wine label approvals (J.A. 55a). Ruefenacht paid $120,000 of the total $250,000 purchase price for Continental's stock, and shortly thereafter abruptly withdrew from the company (J.A. 47a).

B. The Proceedings Below

Ruefenacht then commenced this action, alleging that his purchase of Continental stock was induced by fraudulent and negligent misrepresentations contained in certain financial documents prepared by Christopher O'Halloran (the company's accountant), and made orally by defendants Joachim Birkle (Continental's president, who owned or controlled the remaining 50% of Continental's stock), and petitioner W. George Gould (Continental's corporate counsel). Violations are alleged of sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. 771(2), 77q(a) (1982); section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) (1982); and Rule 10b-5, 17 C.F.R. 240.10b-5 (1984).[1] Also alleged are pendent state claims for fraud and breach of fiduciary duties. The complaint seeks rescission and restitution of the amount paid (J.A. 23a-44a).

Defendant-petitioner Gould moved for summary judgment dismissing the complaint on the ground that limited discovery showed Ruefenacht to have acquired such significant control over Continental's business, and to have participated in the

[1]Hereinafter the Securities Act of 1933, as amended, 15 U.S.C. §§ 77a-77bbbb (1982), will be referred to as the "Securities Act"; and the Securities Exchange Act of 1934, as amended, 15 U.S.C.§§ 78a-78kk (1982), will be referred to as the "Securities Exchange Act."

company's affairs to such a degree, that his stock purchase was not an idle investment with profits to come solely or primarily from the efforts of others. Therefore, Ruefenacht could not claim protection under the federal securities laws, pursuant to the authority of *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, *reh. denied*, 329 U.S. 81 (1946); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975); and *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

The trial court held an evidentiary hearing[2] on the issue of the extent of control over Continental acquired by Ruefenacht in connection with the stock purchase. A number of specific factual findings (summarized under section A above) were made (J.A. 51a-56a), providing the basis for the ultimate factual conclusions that Ruefenacht *was* "an active investor who intended to participate significantly in the management of the business," and *not* "a passive investor who relied on others to manage the business" (J.A. 61a). As a result of Ruefenacht's control over and participation in Continental's affairs, the trial court held that "the profits of the enterprise would not be derived 'solely' or substantially from the efforts of others," and, therefore, under the authority of *Howey*, *Forman* and *Weaver*, dismissed all federal securities law claims. Additionally, the court in its discretion dismissed all pendent state law causes of action (J.A. 61a-62a).

On Ruefenacht's appeal, the Third Circuit held that no economic analysis of the transaction should have been made, and that the securities laws apply to the transaction *a fortiori* because stock with "traditional" attributes was involved. Accordingly, the judgment dismissing Ruefenacht's complaint was reversed and the matter remanded. *Ruefenacht v. O'Halloran*, 737 F.2d 320 (3d Cir. 1984).

[2]The matter was referred to the Magistrate who, after receiving testimonial and documentary evidence, rendered a report and recommendations (J.A. 51a).

SUMMARY OF ARGUMENT

I

The federal securities laws protect passive investments in financial instruments that usually are publicly marketable, and not purchases of assets (such as a business or its property) which may be accomplished by a transfer of stock.

The dominant purposes of the securities laws are to regulate the organized capital markets and to protect "investors." An "investor" in stock in a securities law sense is characterized by an intent to purchase the instrument as an end in itself, and not as a means of acquiring ownership or control over the underlying business or its property. An investor also is characterized by a dependence upon others for information relevant to his purchase, and for a return (or profit) on the capital provided for others' use. In contrast, a non-investor fundamentally seeks to utilize stock as a means to acquire ownership or use of a business or its property. Such a person is in a position to protect himself at various stages of the transaction by obtaining firsthand information, and by influencing corporate profitability.

Securities law protection in particular cases is properly determined, in the light of these dominating statutory purposes, by reference to the economic substance of the transaction. The decision in *Howey* sets forth the key economic determinants of securities law coverage, which are reflective of the statutory goals. Application of the *Howey* criteria to a transaction in stock is entirely consistent with decisional precedent in this Court and with the statutory design.

II

The present transaction fails to qualify for securities law protection under this analysis, because it implicates no federal securities laws concerns.

The transaction fails to satisfy the *Howey* criteria initially because it was entirely private and unique in character, and not

public in any sense. Moreover, because of Ruefenacht's extensive veto rights over fundamental corporate decisions, and his ability to influence the firm's profitability through active participation in its affairs, the transaction does not satisfy the *Howey* requirement that an investment in a "security" be characterized by an expectation of profits to be obtained from the efforts of others. These circumstances require that the federal securities law claims be dismissed, and that the contrary decision and judgment of the Third Circuit Court of Appeals be reversed.

POINT I

THE SECURITIES LAWS PROTECT PASSIVE INVESTMENTS IN FINANCIAL INSTRUMENTS WHICH ARE USUALLY PUBLICLY MARKETABLE, AND NOT PURCHASES OF ASSETS BY MEANS OF A STOCK TRANSFER

This petition seeks to have the Court continue an approach to the determination of federal securities law coverage which it has faithfully followed over the decades. Beginning with *Howey*, the Court *always* has looked to the economic substance of the transactions before it, in the light of the protective purposes of the securities laws, to evaluate whether those purposes will be advanced by according coverage. In the early decades after passage of the securities laws, the Court construed the enactments flexibly to afford coverage to persons and transactions within the spirit but not within the letter of the statutes. But it does not follow from this early history that securities law coverage should now be extended to transactions within the statutes' letter but not their spirit.

The cases show that the paradigm of a "security"[3] in the federal law sense is a passive investment in a financial instrument which is usually publicly marketable. In contrast, this

---

[3]The definition of "security" under the Securities Act is found at 15 U.S.C. 77b(1) (1982); in the Securities Exchange Act the definition is found at 15 U.S.C. 78c(a)(10) (1982).

Court has never held the securities laws to apply to the purchase or sale of assets to be used or consumed by the purchaser. One form of such an asset purchase is the sale of a business, in whole or in part, which on occasion may be accomplished by means of a transfer of stock.

The present case, in economic substance, involves the purchase of a business, and not an idle investment in a financial instrument. It is, as a result, not within the spirit or intendment of the securities laws, and hence is disqualified from coverage thereunder.

A. The Dominant Purposes Of The Securities Laws Are To Protect Investors Dealing In Public Markets, Not Non-Investors Who Use or Consume The Item Purchased

The dominant purposes of the securities laws are to regulate the capital markets and to protect "investors" through compelled disclosures. As stated in *Forman*, 421 U.S. at 849:

> The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors.

Accord Weaver, 455 U.S. at 555 ("The Act was adopted to restore investors' confidence in the financial markets . . ."); and *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) ("One of its [the Security Exchange Act's] central purposes is to protect investors through the requirement of full disclosure by issuers of securities, and the definition of security in § 3(a)(10) necessarily determines the classes of investments and investors which will receive the Act's protections.").

Both factions in the current judicial debate as to when stock is a "security" agree that these were Congress' fundamental aims. *Ruefenacht v. O'Halloran*, 737 F.2d at 334 ("Congress

unquestionably intended that the Act protect 'investors' in the national securities markets."); *Daily v. Morgan*, 701 F.2d 496, 500 (5th Cir. 1983) ("There is no doubt that Congress was primarily concerned with abuses occurring in the financial markets—the national exhanges and over-the-counter markets—through the sales of widely-held securities of large corporations. The legislative history is abundantly clear on this point . . . ."); *Golden v. Garafolo*, 678 F.2d 1139, 1146 (2d Cir. 1982) ("The overbreadth is the consequence of the fact that Congress' core concern was protection of the individual investor trading in public markets for shares of firms about which information is available only through intermediaries."). *Accord Sutter v. Groen*, 687 F.2d 197, 201 (7th Cir. 1982) ("We must ask in other words what class of people Congress wanted to protect by enacting the Securities Exchange Act, and in particular section 10(b). The answer is not in doubt: investors.").

These purposes recently were confirmed by Congress itself in enacting amendments to the definitions of "security" in the Securities Act and Securities Exchange Act. *See* Act of October 13, 1982, Pub. L.97-303, § 1, 96 Stat. 1409. The purpose of the amendments was to resolve a jurisdictional conflict between the Securities and Exchange Commission and other agencies regarding the regulation of various securities options by specifically adding certain types of options to the definitions of a security. *See* 1982 U.S. Code Cong. & Ad. News 2780. The legislative history of the amendments provides in pertinent part that:

> These laws were aimed at *protecting public investors*, assuring market integrity and, most important, restoring investor confidence in order to attract needed funds back into the U.S. capital markets. These goals were, and remain, of paramount concern to Congress.

1982 U.S. Code Cong. & Ad. News at 2781 (emphasis added).This statement reaffirms the primacy, in the securities laws, of the protection of "investors" dealing in "public" markets.

Inherent in this statutory design is a fundamental distinction, at the bottom of the securities laws, between investors and non-investors (or between investments and non-investments). A basic premise of petitioner's position is that Congress intended to draw this distinction, with the result that non-investors are not entitled to federal securities law protection, even though they choose to transact in stock facially meeting the statutory definition of a security. This distinction also is the foundation for the "sale of business doctrine."[4] *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1352 (9th Cir. 1984); *Sutter v. Groen*, 687 F.2d at 201; *Golden v. Garafolo*, 678 F.2d at 1146.

In the broadest generic sense, almost any purchase, at least in part, can be considered an "investment," and hence any purchaser an "investor." Thus, for example, although the purchase of a house or other necessaries are primarily for use or consumption, to the extent a purchaser expects these assets to appreciate in value they can be considered investments as well. It is self-evident, though, that this general sense of the term is not intended to be the basis for securities law coverage.

The fundamental distinction between an investor and a non-investor in a securities context has been described in various ways. *Forman*, citing *Howey*, described an investor as someone "'attracted solely by the prospects of a return' on his investment." *Forman*, 421 U.S. at 852 (citing *Howey*, 328 U.S. at 300). *Forman* contrasted such a person with someone "motivated by a desire to use or consume the item purchased . . . ," 421 U.S. 852-53, to whom the securities laws do not apply. *S.E.C. v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), stated that where an asset becomes the subject of "speculation," it becomes more akin to an investment. *Id.* at 352 n.10. The Seventh Circuit described the distinction as

[4]The sale of business doctrine is merely a shorthand expression for the principle that where the economic essence of a stock transfer is the sale of an asset (*i.e.*, a business), the securities laws do not apply. *See e.g., Golden v. Garafolo*, 678 F.2d at 1140-42.

being between an investor and an entrepreneur, and defined the "entrepreneurial intention" as one "to buy assets to manage, rather than to rent capital to those who want to manage . . ." *Sutter v. Groen*, 687 F.2d at 202.

Emerging from these descriptions is a portrait of an investor as someone who acquires stock in a business as an end in itself; the investment is fundamentally in the financial instrument and not in assets. Stated differently, the stock investor in a securities law sense seeks gain from the fact of ownership of the instrument, and not from his own control or use of the business or its assets. In contrast, a dominant purpose of a non-investor is to acquire ownership or use of assets (*i.e.*, a business or its property), although it may occur that a transfer of stock is utilized as a means to that end. But it is the underlying business entity, and not the instrument, which is the focus of the non-investor's purchase.

An investor is also characterized by a dependence upon others for information relevant to his purchase, and for a return on his investment thereafter. *See Golden v. Garafolo*, 678 F.2d at 1146 (" . . . Congress' core concern was protection of the individual investor trading in public markets for shares of firms about which information is available only through intermediaries.").

It is this element of dependence by investors upon others that renders the latter fiduciaries, owing to investors high duties of trust. The legislative history is clear on this point. As stated by President Franklin D. Roosevelt in his message to the United States Senate:

> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.
>
> * * *
>
> What we seek is a return to a clearer understanding of the

> ancient truth that *those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others.*

77 Cong. Rec. 937 (1933) (emphasis added).

A similar perspective was presented by Congressman Sam Rayburn, a sponsor of the Securities Act, who during his remarks on the floor of the House of Representatives stated:

> [T]he development of this country impresses one that the size of our industrial unit is increasing, and with its growth there has come a dispersion in the ownership of the unit. Today an important part of the wealth of individual citizens consists of interest in great enterprises of which no single person owns a major portion. *Today the owner does not possess actual physical properties but he holds a piece of paper which represents certain rights and expectations. But the owners of these pieces of paper have little control over the physical property; the owners of these pieces of paper carry no actual responsibility with respect to the enterprise or its physical property.*
>
> * * *
>
> We have, on the one hand, 18,000,000 passive citizens having no actual contact with their companies; on the other hand, a few hundred powerful managers directing and controlling the destinies of the companies and the physical properties which they own. The owners of these symbols are entitled to know what the symbols represent. Those who are interested in purchasing these pieces of paper have the right to demand information as to the actual condition of the issuing company. Up to this time such information has depended on the grace of an intrenched management. *These managers are truly trustees. One of their duties as trustees is to furnish security owners, in being and in prospect, with reliable information. This bill has been drawn to enforce that responsibility.*

77 Cong. Rec. 2910, 2917-18 (1933) (emphasis added). The House Committee Report on the Securities Exchange Act is to the same effect:

> As a complex society so diffuses and differentiates the financial interests of the *ordinary citizen that he has to trust others* and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's *dependent position.*

H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5, 78 Cong. Rec. 7703 (1934) (emphasis added).

Thus, a purchaser of stock who is not in a position to obtain or confirm relevant firsthand information regarding a business prior to engaging in a transaction, and who must rely virtually entirely upon others for management of the enterprise, because of his vulnerable position presents a model for coverage under the federal securities laws. Where, in contrast, the purchaser is in a position to protect himself before the transaction by obtaining firsthand information (perhaps by the exercise of an element of negotiating power), and, in addition, after the purchase possesses such control or influence over the enterprise that he is in a position to further protect himself (perhaps by mitigating the effects of fraud or inhibiting further abuses), the protective policies of the securities laws are not implicated. Such a person, able to protect himself at various stages of the transaction, is not an "investor" under the conceptions cited above.

The fact that the dominant purposes of the securities laws are protection of investors and regulation of public markets does not necessarily exclude non-investors who transact privately from coverage by those laws. *United States v. Naftalin*, 441 U.S. 768, 775 (1979) ("But neither this Court nor Congress has ever suggested that investor protection was the sole purpose of the Securities Act."); *Daily v. Morgan*, 701 F.2d at 502 ("However, the fact that Congress was concerned primarily

with large-scale fraud in the capital markets does not mean that it would disapprove of statutory protection against small-scale fraud as well."). But if coverage is to be extended to non-investors, there should be sufficient, even compelling reasons, related to securities regulation, to do so. Certainly, coverage will not be accorded simply because fraud is alleged in connection with a transaction where stock is transferred. The securities laws do not "provide a broad federal remedy for all fraud." *Weaver*, 455 U.S. at 556. Nor, we submit, do the securities laws provide a federal remedy for all fraud where stock is somehow involved in the transaction.

There are no compelling reasons to extend securities law coverage to non-investors, and in fact good reasons not to do so.[5] Such an extension of coverage obliterates the fundamental distinction between investor and non-investor. It also accords coverage to infinitely broad classes of persons and transactions, in effect making the securities laws a "broad federal remedy for all fraud," *Weaver*, 455 U.S. at 556, where stock in any way is involved in the transaction. Such an approach extends securities law coverage to classes of persons and legions of transactions which Congress gave absolutely no indication that it sought to protect. *See Sutter v. Groen*, 687 F.2d at 201 ("No other protected class [besides investors] is mentioned [in the legislative history]; entrepreneurs are not mentioned.") To paraphrase the Court below, if Congress intended the securities laws to cover non-investors, "they certainly made no mention of it." *Ruefenacht v. O'Halloran*, 737 F.2d at 330.

---

[5]It should be pointed out that the private right of action under section 10b and Rule 10b-5 is not one of express legislative enactment, but has been implied by the courts. As such, the parameters of its application are a matter of judicial determination based on the judicial perception of the classes of persons intended to be protected by the statute's underlying purposes. The same is true as to any private right of action that may exist under Section 17 of the Securities Act. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, *reh. denied*, 423 U.S. 884 (1975). To a lesser extent, such discretion may even by exercised by the courts with respect to Section 12 of the Securities Act where Congressionally created rights are involved.

B. Whether The Purposes Of The Securities Laws Will Be Advanced By According Coverage Is Determined By Reference To The Economic Substance Of The Transaction

Decisional precedent in this Court, and statutory authority, fully support an evaluation of the economic substance of a transaction, in the light of the statutes' dominating purposes, to determine securities law coverage.

1) Supreme Court Precedent.

Authority for such an approach is found initially in the axiom of statutory construction that, in determining coverage, every enactment should be read as a whole and in light of its dominant purposes. As stated in *Kokoszka v. Belford*, 417 U.S. 642, *reh. denied*, 419 U.S. 886 (1974):

> When "interpreting a statute, the court will not look merely to a particular clause in which general words may be used, but will take in connection with it the whole statute (or statutes on the same subject) and the objects and policy of the law, as indicated by its various provisions, and give to it such a construction as will carry into execution the will of the Legislature . . . " *Brown v. Duchesne*, 19 How. 183, 194 (1857).

417 U.S. at 650. *See also FAA Administrator v. Robertson*, 422 U.S. 255, 261 (1975).

In *Joiner*, this principle was applied to find oil leases, sold as part of an exploration enterprise, to be securities under federal law. The Court rejected application of a specific rule of statutory construction (*expressio unius est exclusio alterius*) where such application would have led to a result at odds with the enactment's objects and policy, to wit:

> However well these rules [of statutory construction] may serve at times to aid in deciphering legislative intent, they long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of

> context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy.

Joiner, 320 U.S. at 350-51 (footnote omitted).

The Court in *Forman* similarly emphasized the importance of this approach in carving the scope of the meaning of "security" under federal law. The Court stated that "construing these Acts against the background of their purpose," 421 U.S. at 849, may require excluding from statutory coverage even transactions that fall within the letter of the enactments, citing *Holy Trinity v. United States*, 143 U.S. 457, 459 (1892), for the oft-repeated proposition that:

> [A] thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers.

One obvious purpose of construing a statute in the "context" of its dominant purposes is to avoid sweeping within the law transactions and classes of persons which literally may seem to be covered, but which are in fact not within the legislation's "spirit, nor within the intention of its makers." *Id. Cf. Nat. Soc. of Professional Engineers v. U.S.*, 435 U.S. 679, 687 (1978) (stating that Section 1 of the Sherman Act, 15 U.S.C. § 1, "cannot mean what it says."). Put another way, application of this principle guards against unnecessarily extending statutory coverage to matters where to do so would neither advance nor implicate the protective purposes of the law.

Adhering consistently to these principles, for decades this Court has held that coverage of the securities laws is evaluated in light of the economic realities of a transaction and not woodenly applied based upon a literal application of the statutes. *Howey*, 328 U.S. at 299 (the definition of security "embodies a flexible rather than a static principle . . ."); *Forman*, 421 U.S. at 850 (observing that *Joiner* "was not establishing an inflexible rule barring inquiry into the economic realities underlying a transaction."). This approach has led, in cases in this Court

where securities law protection was sought, to an evaluation of the economic substance of the transaction. Where, after such an analysis, the Court has concluded that the statutory purposes will be advanced, securities law coverage has been accorded. *See, e.g., Tcherepnin*, (withdrawable capital shares in a savings and loan association held to be securities); *Howey*, (interests in orange groves as part of an arrangement for cultivating, marketing and remitting the net proceeds to the investor were securities); and *Joiner*, (oil leases sold as part of an exploration enterprise were securities). Where the statutory purposes have not been implicated, coverage has been denied. *See, e.g., Weaver*, (certificates of deposit, and a private contract to share profits where the plaintiff had use of assets in the business, held not to be securities); *Teamsters v. Daniel*, 439 U.S. 551 (1979) (interest in pension plan not a security); and *Forman*, (stock in non-profit housing cooperative not a security). Although the economic analysis in some cases (*i.e.*, *Tcherepnin*, *Howey* and *Joiner*) resulted in an extension of securities law protection to transactions which facially did not meet the statutory definition, the Court never stated that such an analysis was only a one-way street, to be utilized solely where the result would be to expand securities law coverage. No case mentions such a restriction, which would be fundamentally at odds with the principle that every enactment should be construed in light of its purposes. Fidelity to this principle requires that no transaction be immunized from substantive evaluation. The result is neither to expand nor contract the enactments' scope, but rather to *conform* the same to the statutory goals.

The opportunity for courts to evaluate the economic substance of transactions where federal securities law protection is sought was made explicit in *Forman*. The Court there rejected a "literal" approach to application of the securities laws in no uncertain terms:

> We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock," must be considered a security transaction simply

because the statutory definition of a security includes the words "any . . . stock." Rather we adhere to the basic principle that has guided all of the Court's decisions in this area:

> "[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality."

Forman, 421 U.S. at 848 (quoting *Tcherepnin*, 389 U.S. at 332).

The necessity for courts to be able to examine the economic realities underlying a transaction is a product of the fact that the definitions of "security" in the securities acts consist simply of a listing of some of the many and variable instruments and business arrangements identified by Congress as potential securities. As the *Forman* Court stated:

> In providing this definition Congress did not attempt to articulate the relevant *economic criteria* for distinguishing "securities" from "non-securities." Rather, it sought to define "the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."

421 U.S. at 847-48 (citing H.R. Rep. No. 85. 73d Cong., lst Sess. ll (1933)) (emphasis added).

The *Forman* Court also observed:

> Because securities transactions are economic in character Congress intended the application of these statutes to turn on the *economic realities underlying a transaction*, and not on the name appended thereto.

421 U.S. at 849 (emphasis added).

Use of an economic analysis to determine securities law coverage was confirmed in *Weaver*, where the Court stated, in unmistakable terms, that in determining federal securities law coverage:

> *Each transaction* must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

455 U.S. at 560 n.11 (emphasis added).

Forman does not forbid an evaluation of the economic substance of "traditional" instruments. *See Daily v. Morgan*, 701 F.2d 496 (5th Cir. 1983); *Golden v. Garofalo*, 678 F.2d 1139 (2d Cir. 1982); *Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). The source of this erroneous interpretation is *Forman*'s reference to the "traditional" characteristics of stock. In the course of rejecting the literalist view that the name given an instrument is controlling of securities law coverage, the Court stated:

> In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

421 U.S. at 850-51. *Forman*'s reference to "traditional" securities or their characteristics was in the context of discussing a situation where a purchaser reasonably assumes the securities laws to apply (*i.e.*, where a purchaser is "misled," 421 U.S. at 851, into such a belief). By the above quote and following discussion, *Forman* simply stated that such a claim is strengthened where "traditional" securities are involved, because it is more likely that such an expectation would be created in that circumstance.[6]

---

[6]As we show *infra* under Point IC1, the presence of a "traditional" label, such as stock, and attendant "traditional" characteristics, plays a role in determining securities law coverage. Such instruments are presumptively covered by the statutes, subject to rebuttal where the economic realities of the transaction so require.

2) The Context Clauses

The phrase "unless the context otherwise requires," preceding the definitions of the term "security" in both the Securities Act and Securities Exchange Act[7], provides express statutory authority for an evaluation of the economic substance of transactions where securities law protection is sought. *Weaver* makes this clear: "[T]he terms mentioned [in the statutory definition of the term 'security'] are not to be considered securities if 'the context otherwise requires . . . .'" 455 U.S. at 556.

The analysis by the Court below of the origins of the context clauses does not affect this conclusion. *Ruefenacht v. O'Halloran*, 737 F.2d at 330-32. The absence of discussion in the legislative history of the securities laws reconciling the two versions of the prefatory clause proves no more than that Congress never specifically considered whether the sale of a business by means of a transfer of stock is covered by the securities laws. *Daily v. Morgan*, 701 F.2d at 502 ("As far as we can tell from the legislative history, Congress never pondered the sale of business question, being concerned with the grander problems of the day.") In short, no historical analysis or legislative history precludes an analysis of whether, in economic substance, a sale of all or part of a business by the transfer of stock is a transaction in securities under federal law.

Even if, as the Third Circuit suggests, the relevant context is the text of the statute, rather than the economic and factual setting, *see Ruefenacht v. O'Halloran*, 737 F.2d at 330, statutory provisions involved in this case are set in a linguistic context suggesting a need to determine securities law coverage by reference to the statutory purposes. For example, section 10b of the Securities Act, 15 U.S.C.§ 78j, provides:

> § 78j. Manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate

[7]*See supra* note 3.

> commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate *in the public interest* or for the *protection of investors*.

15 U.S.C. § 78j (1982) (emphasis added). The statutory context in which the term "security" is used in section 10b is one where emphasis is placed on the "protection of investors" and the "public interest." Thus, from a textual point of view the meaning of these qualifying terms becomes important in determining the nature of "security" transactions intended to be covered by this section. As shown *supra* under Point IA, basic to this context is a distinction in the law between an "investor" and a "non-investor," and a design to extend securities law coverage only to the former.[8]

Even the Court below, and other Courts of Appeals which reject an economic analysis of transactions involving tradi-

[8]A further statutory "context" of section 10b is that it is immediately preceded by the section that proscribes market manipulation (15 U.S.C. § 78i) and immediately followed by the section that regulates trading by exchange members, brokers and dealers (15 U.S.C. § 78k). Each of these sections deals with prohibited activities on public exchanges, confirming that Congress' dominant (although not exclusive) focus was on regulating the organized capital markets whose operations affect large numbers of persons. As discussed *infra* under Point IC, this focus, while not necessarily excluding private transactions from securities law coverage, makes clear that the protective purposes of those laws are implicated most strongly where a transaction in stock is public, or widespread, in nature; and that those statutes are concerned only minimally with transactions that are entirely private or unique.

tional stock,[9] have applied the context clauses to justify an economic analysis of transactions in *notes*, and to support conclusions that some note transactions are not covered by the securities laws, even though the instruments are facially "traditional." *Exchange National Bank of Chicago v. Touche Ross Co.*, 544 F.2d 1126, 1131-32 (2d Cir. 1976); *Ruefenacht v. O'Halloran*, 737 F.2d at 323-24. *See also Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984); *Landreth Timber Co. v. Landreth*, 731 F.2d 1348 (9th Cir. 1984).

According to the Court below, in the note area there is "some necessity" for such "fine-tuning" of the definition of security, *Ruefenacht v. O'Halloran*, 737 F.2d at 325, in order to avoid sweeping within the securities laws transactions clearly not intended to be covered, which advance no statutory purpose, but which would be covered under a literal approach. Different tests have evolved to distinguish covered from non-covered notes — a "risk capital" test, an "investment" test, and the *Howey* approach, *see* 737 F.2d at 323-24 — and the debate persists as to the merits of each. *Id.* The Third Circuit, in seeking to distinguish between covered and non-covered note transactions has " . . . examined the *entire context* of the note transaction, declining at that time to expound a 'test' . . . that would aid in determining whether there has been a purchase or sale of securities when a personal promissory note is involved." *Ruefenacht v. O'Halloran*, 737 F.2d at 323, citing *Lino v. City Investing Co.*, 487 F.2d 689, 696 n.15 (3d Cir. 1973) (emphasis added). In short, even those courts which reject an economic analysis of transactions in a stock setting, embrace such an approach to evaluate note transactions (albeit using somewhat different tests), to prevent extending securities law coverage where not warranted or necessary.

There is no principled way to reconcile the conclusions that transactions involving notes, which are traditional instru-

[9] *Ruefenacht v. O'Halloran*, 737 F.2d 320 (3d Cir. 1984). *See also Daily v. Morgan*, 701 F.2d 496 (5th Cir. 1983); *Golden v. Garafolo*, 678 F.2d 1139 (2d Cir. 1982).

ments, may be subject to substantive economic evaluation to determine securities law coverage, but the same is not true for traditional stock. *See Landreth Timber Co. v. Landreth*, 731 F.2d at 1353. Nor is it sufficient to say that, unlike in the note setting, there is "no . . . necessity in the stock area" for such an approach. *Ruefenacht v. O'Halloran*, 737 F.2d at 325. The very same compelling rationale applies to both instruments, namely, the need to avoid sweeping within the statute legions of transactions not intended to be covered and where extending securities law protection would advance no statutory purpose.

C. The Economic Factors Cited In *Howey* Permit Extension Of Securities Law Coverage To A Passive Investment In A Financial Instrument, And Denial Of Coverage To The Purchase Of A Business by Means Of A Stock Transfer

The guiding principles set forth in *Howey* are the starting point in the analysis of the economic substance of a transaction where federal securities law protection is sought. *Howey* concluded that an "investment contract" is characterized by "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." *Forman*, 421 U.S. at 852. As stated in *Forman*, these factors are the "touchstone[s]" of the meaning of "security" in federal law, and embody "the essential attributes that run through all of the Court's decisions defining a security." *Forman*, 421 U.S. at 852.

These factors stitch a common thread through the definition of security because they reflect, "in shorthand form," *Forman*, 421 U.S. at 852, an economic substance common to *all* instruments enumerated within the statutory definition. This point is missed by those courts which argue that application of the *Howey* factors to stock distorts the statutory definition by "circumscrib[ing] the scope of the standard terms—'stock', 'note', 'debenture'—to that of the more generous phrases [*e.g.*, investment contract]." *Ruefenacht v. O'Halloran*, 737 F.2d at 329. *See also Golden v. Garafolo*, 678 F.2d at 1144. Whether the "investment" in a security is in stock or in an investment

contract, the transaction must possess these essential attributes to be considered a transaction in a "security" in the federal law sense.

1) Common Venture

The *Howey* requirement of an investment in a "common venture" puts in focus the extent to which a transaction in securities is widespread or "public" in nature. Decisions by this Court consistently have recognized, explicitly or implicitly, the importance of this factor. Thus, in *Joiner*, the campaign to sell assignments of oil leases "was by mail addressed to upwards of 1000 prospects in widely scattered parts of the country and actual purchasers, about fifty in number, were located in at least eighteen states and the District of Columbia." *Joiner*, 320 U.S. at 346. In *Howey*, the units of citrus grove development and related service contracts were offered "to the public," 328 U.S. at 295, many of whom lived in "distant localities," *id.* at 299, and in a limited period 42 persons made purchases. *Id.* at 295. In *Tcherepnin*, the withdrawable capital shares were offered widely to the public, in part through printed solicitations sent through the mails. 389 U.S. at 333. As summarized in *Weaver*: "The unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction as in this case." 455 U.S. at 559.[10]

The principle emerging from these cases is that the more widespread is an offering of stock, the more the protective purposes of the securities laws are implicated. As an offering becomes increasingly widespread, it progressively involves the "public investor," *supra* at p.9, about whom Congress in enacting the securities laws was most concerned. Conversely, to the extent that a transaction in stock is singular or entirely private in character, the protective purposes of the securities laws are implicated to a lesser degree. Thus, in *Weaver*, an important

[10]*See also Great W. Bank Trust v. Kotz*, 532 F.2d 1252, 1258 (9th Cir. 1976); *Lino v. City Investing Co.*, 487 F.2d 689, 694-95 (3d Cir. 1973); *Robbins v. First Am. Bank*, 514 F. Supp. 1183, 1188 (N.D. Ill. 1981).

factor in rejecting securities law coverage of a private contract was that the agreement was "unique," was "negotiated one-on-one by the parties," was not distributed to other potential investors, and was "not designed to be traded publicly." 455 U.S. at 560. Such a private transaction bespeaks elements of negotiation between the parties, and an ability to obtain first-hand information, which places a potential plaintiff in a position to protect himself in the transaction through negotiated disclosures, warranties or other contractual protections. Such a person has little need or cause to claim securities laws protection.

This is not to say that private or face-to-face transactions are *necessarily* excluded from securities law coverage. It is established that the securities laws may apply "to face-to-face sales of stock as well as to transactons in the recognized markets." *Ruefenacht v. O'Halloran*, 737 F.2d at 328; *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6,10 (1971). But on the spectrum from, on one hand, a totally unique transaction between two private contracting parties of equivalent bargaining power who choose to deal in stock, to, on the other, a widespread standardized offering to thousands of distant potential purchasers, it is clear that as the transaction approaches the latter model the protective purposes of the securities laws are increasingly implicated, and hence coverage under those laws becomes progressively certain.[11]

2) Expectation of Profits to be Derived From the Efforts of Others

The requirement that the economic inducement for an "investment" subject to the securities laws be a promise or

[11]There is nothing to the contrary in *United States v. Naftalin*, 441 U.S. 768 (1979), where the Court upheld the criminal conviction of a customer for defrauding his stockbroker in short sale transactions. The Court emphasized that the statutory purpose advanced by according securities law coverage was "to achieve a high standard of business ethics . . . *in every facet of the securities industry.*" *Id.* at 775 (quoting *S.E.C. v. Capital Gains Bureau, Inc.*, 375 U.S. 180, 186–87 (1963)). As shown earlier (*supra* at p. 8-10), regulation of activities in the securities industry (*i.e.*, on the organized exchanges) was clearly one of the primary purposes of the securities laws.

expectation of profits was made clear in *Forman*, where a prime reason for rejecting coverage was the fundamental nonprofit nature of the transaction. *Forman*, 421 U.S. at 853-58. *Accord Daniel*, 439 U.S. at 561-62.

The concept that profits must be "derived from the entrepreneurial or managerial efforts of others," *Forman*, 421 U.S. at 852, encompasses factors relating both to the amount of control possessed by a potential plaintiff and the extent of his activity in the business whose stock is transferred. *Landreth Timber Co. v. Landreth*, 731 F.2d at 1352; *Sutter v. Groen*, 687 F.2d at 202; *Golden v. Garafolo*, 678 F.2d at 1141-42; *King v. Winkler* 673 F.2d 342, 344-45 (11th Cir. 1982). To the extent that a purchaser of stock obtains significant control[12] over fundamental corporate decisions, he is in a position to affect decisions bearing on profitability, and hence is not in the totally dependent position of the paradigmatic "investor" the securities laws seek to protect. The determination in *Weaver* that a "measure of control," 455 U.S. at 560, over the business there militated against securities law coverage supports this conclusion. *See also Landreth Timber Co. v. Landreth*, 731 F.2d at 1352 (" . . . when a person purchases control of a business, he does not make an investment from which he expects profits solely from the efforts of others."). Similarly, where a purchaser of stock actively participates in the enterprise, he may be in a position by his efforts to affect corporate profitability, with the result that he again is not totally dependent upon others for a return of profit. *Golden v. Garafolo*, 678 F.2d at 1149 (Lumbard J., dissenting).

These determinations turn not upon any *per se* "test" (such as the percentage of stock acquired), but must be viewed

[12]Corporate control in a securities law context means the ability to influence corporate direction or policy. *See* 17 C.F.R. § § 230.405, 240.12b-2 (1984). *See also U.S. v. Corr*, 543 F.2d 1042, 1050 (2d Cir. 1976); *S.E.C. v. International Chemical Development Corp.*, 469 F.2d 20, 28 (10th Cir. 1972); *Pennaluna & Co. v. S.E.C.*, 410 F.2d 861, 866 (9th Cir. 1969), *cert. denied*, 369 U.S. 1007 (1970). *Cf. United States v. Byrum*, 408 U.S. 125, 138 n. 13 (1972).

against the spectrum of, on one side, the purchase of a *de minimus* amount of stock attended by little or no participation in the enterprise,[13] to the other extreme of a 100% purchase by a person who manages and controls the business.[14] As plaintiff-purchasers become increasingly able to protect themselves through control or influence over the enterprise, and concomitantly less dependent upon others for a return of profit, such persons progressively become less in need of securities law protection and hence less reason exists to extend coverage to them.

Although not stated explicitly in *Howey*, closely related to an investor's dependence *vel non* upon others is the extent to which a fiduciary or trust relationship is involved in a transaction involving stock. As earlier discussed (*supra* at p. 11-13), a prominent theme of the legislative history of the securities laws is to regard persons who use the money of others upon a promise of profits—the principal targets of the securities laws—as "trustees." This theme was fundamental to the holding in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), which emphasized that "Congress made clear that 'disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web' along with manipulation, investor's ignorance, and the like." *Id.* at ll-12 (citing H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6). In short, the greater the degree of dependence upon others for

[13]Because no *per se* rule applies there is no need to address whether the phrase "solely from the efforts of others," used in *Howey*, 328 U.S. at 301, should be read literally. *See Forman*, 421 U.S. at 852 n. 16; *Lino v. City Investing Co.*, 487 F.2d 689, 692 (3d Cir. 1973).

[14]While we do not expouse a *per se* rule, it is difficult to envision a situation where a 100% stock purchaser who buys from a sole shareholder and thereafter manages the business,would be covered by the securities laws. Such a situation bespeaks a private, negotiated transaction between parties of equivalent bargaining power, no widespread offering, no public investor, etc., and hence, absent strong factors compelling coverage will likely not be subject to the securities laws.

control or management of the enterprise,[15] the more important is the element of trust, and the more likely it will be that the securities laws will apply.

The presence of traditional characteristics in the stock transferred also plays a role in the economic analysis.[16] Traditional instruments will as a practical matter presumptively be covered by the securities laws, because on their faces "they answer to the name or description," *Joiner*, 320 U.S. at 351, of the statutory definition. In such cases the practical burden falls upon the defendant to show that affording securities law coverage to the transaction serves no statutory purpose. The result of this allocation of burdens will be that "most instruments bearing these traditional titles are likely to be covered by the statutes," *Forman*, 421 U.S. at 850, because application of the securities laws is strengthened where traditional titles and characteristics are present. *Id.* at 851-52. Conversely, nontraditional instruments, which by definition are variable in character and do not fall within the statutory definition, as a practical matter presumptively will not be covered by the securities laws, until it is shown that the statutory purposes will be served by such a result.[17]

---

[15]In *Superintendent*, the corporation itself was the defrauded party. The entity was totally subject to the will of the incoming shareholders who perpetrated the fraud.

[16]*Forman* states that the characteristics traditionally associated with stock are the following: the right to receive dividends contingent upon an apportionment of profits; ability to be pledged or hypothecated; conferral of voting rights in proportion to the number of shares owned; and the ability to appreciate in value. 421 U.S. at 851.

[17]Although not here applicable, *Weaver* and *Daniel* show that the existence of other federal law affording special protection to a would-be securities law plaintiff also is a factor in the economic analysis. In *Weaver*, the federal banking laws provided protection to the plaintiff; in *Daniel* the federal pension laws accorded such protection. The fact that other bodies of federal law provided a great measure of protection rendered it "unnecessary," *Weaver*, 455 U.S. at 559, to accord federal securities law protection as well.

D. The *Howey* Economic Analysis Is Effectively Applied To Stock Transactions

Application of the *Howey* analysis to transactions involving stock does no more than evaluate the presence of factors which this Court has held are determinants of whether any transaction can be said to involve securities in the federal law sense. There is nothing revolutionary in this approach; to the contrary, *Howey* and its progeny have applied no other manner of evaluation.

Because of hypothesized cases involving stock where application of the *Howey* analysis may be difficult, some courts reject the approach in its entirety, on the rationale that the difficulty of line-drawing shows the distinction to be incapable of effective application in a stock context. *Ruefenacht v. O'Halloran*, 737 F.2d at 332-33; *Daily v. Morgan*, 701 F.2d at 503; *Golden v. Garafalo*, 678 F.2d at 1145-46, 1149 (Lumbard J., dissenting). *See also* FitzGibbon, *What Is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 Minn. L. Rev. 893, 905-08 (1980); Coffey, *The Economic Realities of a "Security": Is there a More Meaningful Formula?*, 18 Case W. Res. L. Rev. 367, 374 (1967).

This is the tail wagging the dog. These courts turn a blind eye to fundamental distinctions in the securities laws because the means of carrying out Congress' intent are anticipated (or speculated) to be unworkable, even though *Howey* and other decisional precedent show the contrary to be true. Such an approach "is to go awfully far for the sake of avoiding having to make some distinctions." *Sutter v. Groen*, 687 F.2d at 202. *Accord Golden v. Garafalo*, 678 F2d. at 1149 (Lumbard, J., dissenting).[18]

Nor does application of the *Howey* analysis to stock transactions result in "arbitrary" distinctions. *See Ruefenacht v.*

---

[18]The Securities and Exchange Commission may have an important role to play in refining and amplifying the *Howey* factors in specific situations, consistent with its statutory role to promulgate rules and regulations "for the protection of investors." 15 U.S.C. § 77c (b) (1982).

O'Halloran, 737 F.2d at 335-36; *Golden v. Garafalo*, 678 F.2d at 1146. There is nothing arbitrary about the fundamental investor/non-investor distinction underlying the securities laws; the *Howey* approach allows this distinction to be made in specific cases by reference to factors designed to determine whether particular persons are within the intended ambit of securities law protection. It is not arbitrary to accord securities law coverage only to those parties to a stock transaction who fall within the classes Congress sought to protect, rather than woodenly extending coverage to persons fully able to protect themselves, simply because an instrument denominated "stock" is utilized in the transaction.[19]

Neither does application of an economic evaluation to stock transactions open the "floodgates" of federal court litigation. It is submitted that coverage of most transactions—particularly those involving the organized exchanges, widespread offerings, and recognized fiduciary relationships—will be clear. Moreover, we ask which approach to coverage truly opens the federal litigation "floodgates," an approach which permits an economic evaluation with the result that some cases will be excluded from federal law coverage, or one which automatically places within federal jurisdiction an infinite number of garden-variety commercial transactions involving stock.

Those courts which reject application of the *Howey* evaluation to stock transfers, and instead embrace a "traditional/non-traditional stock" distinction as the basic theorum of securities law coverage, view securities transactions only from the vantage point of the instrument involved, and do not properly take into consideration the classes of persons or nature of transactions intended to be covered. *See Landreth Timber Co. v.*

[19]Concerns that application of an economic analysis would exclude from coverage many tender offers are unjustified. *See Daily v. Morgan*, 701 F.2d at 503. As an area singled out for special protection, *see e.g.*, 15 U.S.C. § 78(n) (1982), tender offers may be imbued with a specific Congressional intent to accord federal law protection. This factor may of itself be controlling in the determination of coverage.

Landreth, 731 F.2d at 1352. Such courts fail to accord any manner of recognition to the primary statutory purposes to protect *persons* (*i.e.*, investors) who passively invest in financial instruments, and not to purchasers of assets, such as a business, through the transfer of stock.[20]

Nor is automatically extending coverage to stock necessary to facilitate the flow of capital or the marketability of instruments. *Ruefenacht v. O'Halloran*, 737 F.2d at 324. Surely the capital raising functions of the organized markets (where most transactions clearly are covered by federal law) will in no way be inhibited by a case-by-case analysis of coverage to be accorded transactions in other spheres. Nor will non-exchange transactions be inhibited, because "doubts as to the coverage of the antifraud provisions of the securities laws are unlikely to impede otherwise profitable transactions by persons able to protect themselves by contract." *Golden v. Garafolo*, 678 F.2d at 1150 (Lumbard, J., dissenting).

Because purchasers of assets, such as a business, fundamentally seek to "use or consume the item purchased," *Forman*, 421 U.S. at 853, it is entirely fair and proper to relegate such persons to common law relief. State law remedies, including remedies based upon contract and deceit, are specifically adapted and fully adequate to protect the purchaser of a business enterprise. *See S.E.C. v. Capital Gains Bureau, Inc.*, 375 U.S. 180, 194-95 (1963) (observing that common law "doctrines of fraud and deceit" are specifically adapted to controversies concerning "tangible items of wealth" as opposed to "such intangibles as . . . securities"); *and Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-80 (1977) (declining to "bring within [the securities laws] a wide variety of corporate conduct tradi-

[20]The "traditional/non-traditional" approach finds no authoritative support in the proposition that because the securities laws are "remedial" they should be expansively applied. This Court has long made clear that specific rules of statutory construction (such as that requiring expansive reading of remedial legislation) "long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose." *Joiner*, 320 U.S. at 350.

tionally left to state regulation."). *Green* held that undue "extension of the federal securities laws would overlap and quite possibly interfere with state corporate law," and observed that "[a]bsent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities . . . ." *Green* explicitly declined to extend the federal securities laws "to 'cover the corporate universe.'" *Id.* at 479-80. *See also Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 40-41 (1977); *Forman*, 421 U.S. at 859 n.26; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 n.9, *reh. denied*, 423 U.S. 884 (1975).

The securities laws provide significant advantages to plaintiffs, and hence present a potential for abuse where not needed to compensate for the dependent position of a true stock investor in the federal law sense. As this Court observed in *Wilko v. Swan*, 346 U.S. 427, 435 (1953), "the Securities Act was drafted with an eye to the disadvantages under which buyers labor." This Court's decisions accordingly have construed the securities laws liberally to minimize procedural and substantive burdens recognized at common law. *See, e.g., Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89 (1983). While the disadvantageous position of a security investor justifies such special protections, the same cannot be said for a non-investor. Rather, conferring special substantive and procedural advantages to a plaintiff in what amounts to the sale of a business by means of a transfer of stock, presents dangers of serious abuse. Such plaintiffs are thus enabled to ignore negotiated contract terms by alleging a host of "nondisclosures" after obtaining possession of the business, and to contend that each such omitted fact, whether or not actually relied upon, constitutes a fraud justifying rescission. As this Court stated in *Blue Chips Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975): "There has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness . . . ." *Id.* at 739. Extending securites law coverage to non-investors who purchase assets to use or consume only exacerbates these concerns.

POINT II

THE PRESENT TRANSACTION FAILS TO QUALIFY FOR COVERAGE UNDER THE FEDERAL SECURITIES LAWS

The trial court held that because an economic analysis of the subject transaction showed Ruefenacht to have intended to exercise joint control of the Continental business with a co-shareholder and to have been an active investor participating significantly in the management of the business (J.A. 61a), the transaction failed to meet the standards announced in *Howey* and *Forman* for securities law coverage in that "the profits of the enterprise would not be derived 'solely' or substantially from the efforts of others." (J.A. 61a). This conclusion is fully consistent with the purposes of the securities laws, and with decisional authority in this Court construing those enactments.

The record establishes (*see supra* at p. 3-5) that, in connection with his purchase of Continental's stock, Ruefenacht acquired control over the affairs of the business such that no decision fundamental to the company's structure or operations could be made without his approval. It also was established that Ruefenacht actively participated in the enterprise in significant ways (*e.g.*, by attending numerous regular meetings with suppliers, soliciting contracts to import beverages on behalf of the firm, participating in hiring key personnel, and issuing directions to the company's counsel regarding securing wine label approvals), such that he was in a position to substantially influence corporate profitability. Part of the consideration for these efforts was to be a salary from the company of $24,000 annually, and the fact that Ruefenacht would be receiving a salary and other compensation as a Continental employee was confirmed in sworn representations made as a basis for obtaining a state liquor license (or solicitor's permit).

These circumstances bespeak an intention by Ruefenacht to use the business, assets and operations of Continental to earn a livelihood through *his own* participation in the business, and

not a purpose to passively invest in a financial instrument with profits from the investment to come from the efforts of others. In short, the economic substance of this transaction was the purchase by Ruefenacht of one-half of the Continental business for his own substantial entrepreneurial purposes, accomplished by means of a transfer to him of 50% of the company's stock.

Application of the *Howey* analysis to this transaction demonstrates that no federal securities law purposes are advanced by according coverage here. The *Howey* requirement of a "common venture," *supra* at p. 24-25, is not met, because it is clear that the stock transfer here was a purely private transaction, "negotiated one-on-one," *Weaver*, 455 U.S. at 560, with "unique" features, and was "not designed to be traded publicly." *Id.* No "public" offering or investment was involved in the transaction, and no organized exchange, or the regulation thereof, is concerned in any way. *United States v. Naftalin*, 441 U.S. 768 (1979). Hence, the purposes of the securities laws to protect such transactions or persons are in no way implicated.

The *Howey* standard requiring dependence upon others for a return of profit, *supra* at p. 25-28, is also not satisfied, by reason of Ruefenacht's extensive veto rights over the company's affairs, taken together with his active participation therein and concomitant ability to fundamentally influence corporate direction and profitability. These factors provided Ruefenacht with a significant "measure of control," *Weaver*, 455 U.S. at 560, over the enterprise, such that he was substantially dependent upon himself, not others, for a return of funds from the business. He therefore is not a member of the class of dependent investors which *Howey* found the securities laws seek to protect, and consequently should not be accorded securities law coverage.[21]

[21]The stock purchased by Ruefenacht lacked several of the "traditional" characteristics of stock, *see Forman*, 421 U.S. at 851-52, further militating against coverage. Although the Magistrate made no specific finding on this point, the record is clear that the stock lacked the characteristics of free transferability, the right to dividends and the right to be pledged or hypothecated. These restrictions are found in the shareholders agreement (R. App. 238a-269a) which the Magistrate found plaintiff intended to sign (J.A. 52a). Such restrictions, moreover, were in part specifically confirmed by plaintiff who testified that a transfer of shares was one of the "top level" decisions both he and Birkle could veto. (R. Tr. Nov. 19, 1982, T137-11 to T138-23).

CONCLUSION

For all of the above reasons, the judgment of the Court of Appeals should be reversed and the case remanded to the District Court with instructions to dismiss the complaint with costs and disbursements.

Respectfully submitted,

ROBERT C. EPSTEIN
Attorney for Petitioner
W. GEORGE GOULD

HANNOCH, WEISMAN, STERN,
BESSER, BERKOWITZ & KINNEY,
P.A.
744 Broad Street
Newark, New Jersey 07102
(201) 621-8800

No. 84-165

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

W. GEORGE GOULD,

Petitioner,

v.

MAX A. RUEFENACHT,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

---

JOINT APPENDIX

ROBERT C. EPSTEIN, ESQ.
Hannoch, Weisman, Stern, Besser, Berkowitz & Kinney, P.A.
744 Broad Street
Newark, New Jersey 07102
(201) 621-8800
Counsel for Petitioner

PETER S. PEARLMAN, ESQ
Cohn & Lifland, Esqs.
Park 80 Plaza West One
Saddle Brook, New Jersey 07662
(201) 845-9600
Counsel for Respondent

PETITION FOR CERTIORARI FILED JULY 27, 1984
CERTIORARI GRANTED NOVEMBER 13, 1984

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

TABLE OF CONTENTS

DOCKET ENTRIES IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY

Plaintiff
RUEFENACHT, MAX A.

Defendants
O'HALLORAN, CHRISTOPHER J.

CHRISTOPHER J. O'HALLORAN,
Third party plaintiff,

VS.

W. GEORGE GOULD, ESQ.,
Third Party Defendant.

W. GEORGE GOULD,
Third-party plaintiff,

-VS-

DAVID BERNSTEIN, AUTOBERN TRADING CO., INC.,
ERNEST STOECKLIN, LENZENHOF GMBH
Third-party defendants

CAUSE
(Cite the U.S. Civil Statute under which the Case is Filed and Write a Brief Statement of Cause)

Securities Exchange Act of 1933, 15 USC § 77; Breach of Fiduciary Duty

---

Attorneys

Cohn & Lifland
Park 80 Plaza West One
Saddle Brook, N.J. 07662
(201) 845-9600

Lum, Biunno & Tompkins, Esqs.
550 Broad Street
Newark, NJ 07102
(For Christopher J. O'Halloran)

Dunne & Waller, Esqs.
712 Kearny Avenue
Kearny, N.J. 07032
Autobern Trading Co.

Hochberg & Simon, Esqs.
80 Main St.West Orange, NJ 07052
(201) 736-5880
(D. Bernstein)

JS6 6-28-83

FILING FEES PAID			STATISTICAL CARDS	
DATE	RECEIPT NUMBER	C.D. NUMBER	CARD	DATE MAILED
12-24-80	$60.00 27683		JS-5	
6-28-83	$70.00 #060857		JS-6	

PLAINTIFF	DEFENDANT	
Max A. Ruefenacht,	Christopher J. O'Halloran, etal	Docket No. 80-4097 Page__of__Page__

DATE	NR.	PROCEEDINGS
12-24-80	1	Complaint with *Jury Demand* filed 12-23-80.
12-24-80		Summons issued. (20 days)
2-4-81	5	Clerk's Order extending time for defendant Christopher J. O'Halloran to answer complaint from 2-3-81 to 2-18-81, filed 2-3-81. (Notice Mail)
2-19-81		Alias Summons issued as to defendant Joachim K. Birkle. (20)
3-4-81	10	Alias Summons and Affidavit of Service of Complaint on Feb. 25, 1981, as to defendant Joachim K. Birkle filed 3-3-81.
3-4-81	11	Summons returned unexecuted filed 3-3-81.
4-3-81	12	Stipulation and order extending time of defendant Christopher J. O'Halloran to answer complaint to April 3, 1981, filed 4-2-81. (Sarokin) Notice mailed
4-6-81	13	*Answer* of defendant, Christopher J. O'Halloran, *crossclaims* for contribution and indemnification against co-defendants, third-party complaint and demand for *jury*, filed 4-3-81.
4-6-81	14	Proof of service of answer of defendant, Christopher J. O'Halloran, crossclaims for contribution and indemnification, third party complaint and demand for jury, filed 4-3-81.
4-6-81		Third party summons issued. (20 days)

DATE	NR.	PROCEEDINGS
4-14-81	16	Summons on third-party complaint and Affidavit of Service returned served on third-party defendant, W. George Gould, Esq. on 4-8-81, filed 4-13-81.
4-29-81		Alias summons issued as to defendant, Continental Import & Export, Inc. (20 days)
5-6-81	18	Interrogatories of plaintiff directed to defendant, Christopher J. O'Halloran, filed 5-5-81.
5-11-81	19	Alias summons and Affidavit of Service of alias summons and complaint returned served on Continental Import and Export, Inc., on 5-7-81, filed.
5-28-81	20	Stipulation and Order extending time for third-party defendant, W. George Gould to respond to third-party complaint to 6-17-81, filed 5-27-81. (Meanor) Notice Mailed
6-5-81	21	Plaintiff's request for entry of default as to defendants, Joachim K. Birkle and Continental Import & Export, Inc., filed 6-4-81.
6-5-81		Default of defendants, Joachim K. Birkle and Continental Import & Export, Inc., for failure to appear, entered.
6-22-81	22	Notice of motion of third-party defendant, W. George Gould for dismissal of third-party complaint or alternatively to direct third-party plaintiff, Christopher J. O'Halloran to provide a more definite statement of the third-party claims returnable 7-13-81 and proof of service, filed 6-19-81. (Brief submitted)
6-29-81	23	Notice of plaintiff to take deposition of W. George Gould, filed 6-26-81.

DATE	NR.	PROCEEDINGS
6-29-81	24	Notice of plaintiff to take deposition of Christopher J. O'Halloran filed 6-26-81.
7-6-81	25	Request of third party defendant, W. George Gould for production of documents directed to plaintiff filed 7-2-81.
7-6-81	26	Notice of third party defendant, W. George Gould to take deposition of Max A. Ruefenacht filed 7-2-81.
7-10-81	28	Request of plaintiff for entry of default judgment against Joachim K. Birkle and Continental Import & Export, Inc., and Affidavit of amount due and of non-miliary service filed 7-9-81.
7-10-81	29	Interrogatories of Christopher J. O'Halloran directed to plaintiff filed 7-9-81.
7-14-81	31	Notice of defendant Christopher J. O'Halloran to take deposition of plaintiff and request for production of documents, filed 7-13-81.
7-17-81		Hearing on motion of third-party defendant, W. George Gould for dismissal of third-party complaint or to direct third-party plaintiff, Christopher J. O'Halloran to provide more definite statement. Ordered motion granted in part and denied in part. Order to be submitted. (Perretti) (7-13-81)
7-30-81	33	*Default judgment for $120,000.00 in favor of plaintiff, Max A. Ruefenacht and against defendants, Joachim K. Birkle and Continental Import & Export, Inc., with costs, filed.* Notice Mailed
7-30-81	34	Plaintiff's costs taxed in the sum of $83.60, filed

DATE	NR.	PROCEEDINGS
8-12-81	35	Order directing defendant-third-party plaintiff, Christopher J. O'Halloran to provide a more definite statement in the third party complaint, filed 7-30-81. (Perretti) Notice Mailed
8-21-81	36	Defendant-third party plaintiff, Christopher J. O'Halloran's more definite statement of third-party complaint, filed 8-20-81.
8-27-81	38	Clerk's order extending time for third-party defendant, W. George Gould, Esq. to answer third party complaint or for more definite statement for 15 days, filed. (Notice Mailed)
9-10-81	39	Notice of motion by plaintiff for leave to file an amended complaint ret. 10-13-81 and affidavit of service, filed. (Brief submitted)
9-16-81	40	*Answer* of third-party defendant, W. George Gould, Esq. to more definite statement of the *Third-Party Complaint*, filed 9-15-81.
9-25-81	41	Interrogatories of third party defendant, W. George Gould, Esq. directed to third party plaintiff, Christopher J. O'Halloran and request for production of documents, filed.
9-28-81	42	Interrogatories of third party defendant, W. George Gould, Esq., directed to plaintiff and request for production of documents, filed.
10-15-81		At call for hearing on motion by plaintiff for leave to file an amended complaint, court indicated consent order to be submitted (Perretti) (10-13-81)

DATE	NR.	PROCEEDINGS
11-4-81	43	Answers of plaintiff to interrogatories of defendant, Christopher J. O'Halloran, filed.
11-5-81	44	Interrogatories of plaintiff directed to third-party defendant, W. George Gould, filed.
11-17-81	45	Consent order permitting plaintiff leave to file an amended complaint etc., filed 11-16-81. (Perretti) Notice Mailed
11-24-81	46	Amended Complaint and *Jury* Demand and affidavit of service, filed.
12-16-81	47	Clerk's order extending time for third-party defendant, W. George Gould to answer amended complaint for a period of 15 days, filed 12-15-81. Notice Mailed
12-21-81	48	Answers of defendant/third-party plaintiff, Christopher J. O'Halloran to interrogatories of plaintiff, filed 12-18-81.
12-21-81	49	Answers of defendant/third-party plaintiff, Christopher J. O'Halloran to interrogatories of third-party defendant, W. George Gould, filed 12-18-81.
1-4-82	51	Interrogatories of defendant/third-party plaintiff, Christopher J. O'Halloran directed to third-party defendant, W. George Gould, filed 12-31-81.
1-11-82	53	Stipulation and order extending time for the third-party defendant, W. George Gould to answer the amended complaint for 30 days to January 30, 1982, filed 1-8-82. (Sarokin) Notice Mailed
1-18-82	54	Notice of Defendant W. George Gould to take deposition of Joachim K. Birkle filed.
2-4-82	55	*Answer* of defendant, W. George Gould to amended complaint; *crossclaims* against co-defendants, Joachim K. Birkle, Continental Import & Export, Inc., and Christopher J. O'Halloran; *Third-Party Complaint* and *Jury* Demand, filed.

DATE	NR.	PROCEEDINGS
2-4-82		Third-party summons as to third-party defendants, David Bernstein and Autobern Trading Co., Inc., issued. (35 days)
2-4-82		Third-party summons as to third-party defendant, Ernest Stoecklin, issued. (20 days)
2-4-82		Summons on crossclaim as to defendant, Continental Import & Export Inc., issued.
2-4-82		Summons on crossclaim as to defendant, Joachim K. Birkle, issued.
2-11-82	59	Deposition of Max A. Ruefenacht taken 12-21-81, filed 2-10-82.
2-11-82	60	Continued deposition of Max A. Ruefenacht taken 1-19-82, filed 2-10-82.
3-2-82	62	Notice of motion of defendant/third-party plaintiff, W. George Gould for dismissal of amended complaint for lack of jurisdiction returnable 3-22-82 and proof of service, filed 3-1-82. (Brief submitted)
3-8-82	63	Summons on third-party complaint returned unexecuted as to third-party defendants, David Bernstein and Autobern Trading Co., filed 3-5-82.
3-11-82		Alias summons on third-party complaint as to third-party defendant David Bernstein and Autobern Trading Co., Inc., issued. (35 days)
3-2-82	65	Summons on third-party complaint returned served on third-party defendant, Ernest Stoecklin on 2-9-82, filed 3-11-82.
3-22-82	66	Alias summons on third-party complaint returned served on third-party defendants, David Bernstein and Autobern Trading Co., on 3-17-82, filed.

DATE	NR.	PROCEEDINGS
3-23-82	67	Deposition of Joachim K. Birkle taken 1-29-82, filed.
3-31-82	68	Affidavit of Max A. Ruefenacht, filed.
4-5-82	69	*Answer* of third-party defendant, Ernest Stoecklin to *third-party complaint* and *jury* demand, filed 4-2-82.
4-5-82	70	Affidavit of Theresa A. Branin, filed 4-2-82.
4-8-82	71	Stipulation and order extending time for third-party defendant, Ernest Stoecklin to answer third-party complaint to April 1, 1982, filed. (Fisher) Notice Mailed
4-19-82	72	Answers of Defendant/Third Party Defendant W. George Gould to Initial Interrogatories of Defendant/Third Party Plaintiff Christopher J. O'Halloran filed 4-16-82.
4-19-82	73	Answers of Defendant/Third Party Defendant W. George Gould to First Set of Interrogatores of Plaintiff filed 4-16-82.
4-19-82	74	Affidavit of Service of Answers to Interrogatories (Docs. 72 & 73) of defendant/third party defendant W. George Gould filed 4-16-82.
4-20-82	75	Deposition of Christopher J. O'Halloran taken March 25, 1982, filed.
4-21-82	76	Affidavit of Plaintiff Max A. Ruefenacht filed 4-20-82.
4-28-82		Hearing on motion of defendant/third-party plaintiff, W. George Gould for dismissal of amended complaint for lack of jurisdiction. Ordered motion denied without prejudice. Order to be submitted (Sarokin) 4-26-82)
5-3-82	77	*Answer* of third-party defendant, David Bernstein to third-party complaint and *jury* demand, filed.

DATE	NR.	PROCEEDINGS
5-7-82	78	Order denying motion of defendants, W. George Gould and C.J. O'Halloran and third-party defendant, E. Stoecklin for summary judgment, filed 5-6-82. (Sarokin) Notice Mailed
5-11-82	79	*Answer* of third-party defendant, Autobern Trading Co., Inc., to third party complaint and jury demand, filed 5-10-82.
5-11-82	80	Affidavit of Doreen E. Ballantyne, filed 5-10-82.
5-20-82	81	Deposition of Christopher J. O'Halloran taken 4-2-82, filed.
6-7-82		Status Conference. (Sarokin) (6-4-82)
6-14-82	82	Substitution of attorney on behalf of third-party defendant, Ernest Stoecklin, filed.
6-24-82	83	Notice of plaintiff to take deposition of Joachim K. Birkle and request for production of documents, filed.
6-24-82	84	Notice of motion by plaintiff for reconsideration of court's order. limited the denial of defendants' motion for summary judgment without prejudice and ordered motion be denied with prejudice 7-26-82 and affidavit of mailing, filed. (Brief attached)
7-7-82	85	Bench Opinion, filed 7-6-82. (Sarokin) (denying motion of defendants for summary judgment.)
8-11-82	86	*Transcript* of Proceedings held 6-24-82, filed.
8-30-82	87	Notice of plaintiff to take deposition of defendant, W. George Gould, filed.
9-17-82	88	Affidavit of mailing of copy of memorandum of defendant, W. George Gould in opposition to motion of plaintiff for reconsideration, filed 9-16-82.

DATE	NR.	PROCEEDINGS
10-12-82		Third-party summons as to third party defendant, Lenzenhof GmbH, issued. (35 days)
10-13-82		At call for hearing on motion by plaintiff for reconsideration of Court's order which limited the denial of defendants' motion for summary judgment without prejudice and ordered motion be denied with prejudice, Court indicated motion to be decided pursuant Rule 70. (Sarokin) (10-12-82)
10-18-82	88	Notice of motion of plaintiff to direct defendant, W. George Gould to produce documents at his deposition returnable 10-18-82 and affidavit of service, filed 10-14-82. (No brief)
10-19-82	89	Notice of motion of paintiff for a Writ of Ne Exeat or in the the alternative for a Writ of Capias Ad Satisfaciendum against defendant, Joachim K. Birkle returnable 10-25-82, filed 10-18-82. (Brief submitted)
10-20-82		Hearing on motion of plaintiff to compel production of documents by defendant W. George Gould at his deposition pursuant to a request to produce documents. Ordered motion granted in part and denied in part. Order to be submitted. (Perretti) (10-1-82)
10-26-82	91	Affidavit of service of copy of notice of motion, supporting affidavit proposed order, Writs and Memorandum of Law, filed 10-25-82.
10-26-82		Hearing on motion of plaintiff for Writ of Ne Exeat or in the alternative for a Writ of Capias Ad Satisfaciendum against defendant, Joachim K. Birkle. Ordered motion granted for Writ of Ne Exeat. Order to be submitted. (Sarokin) (10-25-82)

DATE	NR.	PROCEEDINGS
11-22-82	93	Transcript of hearing held 6-24-82, filed 11-19-82.
11-23-82		$5,000.00 deposited in registery on 11-19-82.
11-23-82	94	Clerk's certificate of Cash Deposit, filed.
11-23-82	95	Order directing the Court to issue Writ of Ne Exeat as to defendant Joachim K. Birkle and directing plaintiff to post a bond for $5,000.00 as a condition for the issuance of Writ etc., filed 11-19-82. (Sarokin) Notice Mailed
11-23-82		Writ of Ne Exeat as to Joachim K. Birkle, issued.
2-10-82	97	Affidavit of Frederick R. Dunne, Jr., filed 12-9-82.
1-5-83	98	Order extending the return date of the Writ of Ne Exeat as to defendant, Joachim K. Birkle to 1-31-83, filed 1-4-83. (Sarokin) Notice Mailed
1-5-82	99	Affidavit of Edward T. Ehler, filed 1-4-83.
1-5-83	100	Transcript of hearing held 11-19-82, filed.
1-21-83	101	Order denying motion of plaintiff for reconsideration of order of 5-6-82, which limited the denial of motion of defendants for summary judgment etc., filed. (Sarokin) Notice Mailed
1-31-83	102	Report and Recommendation, filed. (Perretti) Notice Mailed
2-15-83		Writ of Execution issued and recorded in Book AA on Page 98 of the Book of Executions. (mailed to U.S. Marshal - Newark)
2-17-83	103	Order directing Gail Lowenstein Realtors to cooperate with the U.S. Marshall and permit them to enter the former residence of defendant, Joachim K. Birkle, located at 247 Underhill Road, South Orange, New Jersey, filed 2-14-83. (Sarokin) Notice Mailed

DATE	NR.	PROCEEDINGS
2-17-83	104	Affidavit of Max Ruefenacht, filed 2-14-83.
2-17-83		Hearing on application of plaintiff for order directing Gail Lowenstein Realtors to cooperate with U.S. Marshal to enter residence of defendant, Joachim K. Birkle to execute writ of execution. Ordered application granted. (Sarokin) (2-14-83)
2-25-83	105	Notice of motion of defendant, W. George Gould for summary judgment dismissing complaint returnable 3-28-83, filed 2-24-83. (Brief submitted)
2-25-83	106	Affidavit of mailing of copy of notice of motion, proposed order and supporting brief, filed 2-24-83.
3-30-83		Hearing on motion of defendant, W. George Gould for summary judgment dismissing complaint. DECISION RESERVED. (Sarokin) (3-28-83)
5-3-83	107	Bench Opinion, filed 4-29-83. (Sarokin) (regarding motion of W. George Gould for summary judgment etc.)
5-13-83	108	Order directing the Clerk of the court to release the sum of $5,000.00 to plaintiff deposited on 11-19-82 for issuance of a Writ of Ne Exeat etc., filed 5-12-83. (Sarokin) Notice Mailed
5-16-83	109	*Order granting motion for summary judgment with costs in favor of defendant, W. George Gould and against plaintiff, Max A. Ruefenacht; and dismissing complaint, filed 5-16-83.* (Sarokin) Notice Mailed
6-28-83	110	Notice of appeal of plaintiff, filed 5-26-83 at 1:00 P.M.

DATE	NR.	PROCEEDINGS
6-28-83		Copies of notice of appeal sent to Cohn & Lifland, Esqs., Lum, Biunno & Tompkins, Dunne & Waller, Esqs., Hochberg & Simon, Esqs., James D. Opfer, Jr., Esq. and Clerk U.S.C.A.
6-30-83	111	Amended, order granting motion for summary judgment as to all defendants for lack of jurisdiction without costs, filed 6-29-83. (Sarokin) Notice Mailed (Copy sent to U.S.C.A.)
7-13-83	113	Amended notice of appeal of plaintiff, filed 7-12-83 at 8:30 A.M.
7-13-83		Copies of notice of appeal sent to Cohn & Lifland, Esqs., Lum, Biunno & Tompkins, Esqs., Dunne & Waller, Esqs., Hochberg & Simon, Esqs., James D. Opfer, Jr., Esq. and Clerk, U.S.C.A.

UNITED STATES COURT OF APPEALS
FOR THE THIRD COURT

Case Closed _____ DOCKET NO. 83-5493

Related Cases _____ CALENDARED FOR: 5-14-84

Transferred from C.A. Misc. Record No. _____

ORIGIN: DIST OF NJ-Newark

DC DOCKET NO. 80-4097

DC JUDGE H. Lee Sarokin

FILED IN DC 12-23-80

NOA FILED 5-26-83: Amended 7/12/83

CASE TYPE CIVIL-Securities Exchange Act

DOCKETED: 6-30-83

☒ Fee Paid ☐ IFP ☐ CJA

☐ CPC Granted _____

DISCLOSURE Applt. 7-11-83

STATEMENT Appee. 7-11-83 [W. Geo. Gould] see below

TITLE OF CASE

RUEFENACHT, MAX A.,

VS.

O'HALLORAN, CHRISTOPHER J., JOACHIM K. BIRKLE AND CONTINENTAL IMPORT & EXPORT, INC., AND W. GEORGE GOULD

CHRISTOPHER J. O'HALLORAN,

Third-party plaintiff

VS.

W. GEORGE GOULD, ESQ.,

Third-party defendant

W. GEORGE GOULD,

Third-party plaintiff

VS.

DAVID BERNSTEIN, AUTOBERN TRADING CO., INC., ERNEST STOECKLIN, LENZENHOF GMBH,

Third-party defendant

RUEFENACHT, MAX A.,

Appellant

APPEARANCES

APPELLANT/PETITIONER:
Peter S. Pearlman 7-11-83
Cohn & Lifland, Esqs.
Park 80 Plaza West One
Saddle Brook, NJ 07662-5865
201-845-0600

APPELLEE/RESPONDENT:
Robert C. Epstein 7-11-83
Hannoch, Weisman, Stern,
Besser, Berkowitz
& Kinney, P.A.
744 Broad Street
Newark, NJ 07102
201-621-8800
[W. George Gould]

George S. Hochberg 12-8-83
Richard I. Simmon 8-17-83
Hochberg & Simon, P.A.
80 Main Street
DISC. STMT 8-17-83
West Orange, NJ 07052
201-736-5880
[David Bernstein]

NO. 83-5493

RECORD, EXHIBITS & BRIEF INFORMATION/Filing:	
10-28-83 Partial Rec. or Cert. List	
____ Record on Appeal ☐ IMPOUNDED	
Covers # ____	
Transcript filed in DC:	
____ 1st Supp. Record	
____ 2nd Supp. Record	
____ Exhibits ☐ EX. RM. ☐ SAFE	
____ Administrative Transcript	
10-28-83 Briefing Notice Issued____	Covers # ____
12-6-83 Brief for Applt. MS 12-6-83	
____ Brief for Applt./ Cross Appee.	
1-4-84 Brief for Appee. MS 1/4/84 (10cc) (Gould)	
1-6-84 Brief for Appee. MS 1-6-84 (11cc) (O'Halloran)	
____ Brief for Appee.	
____ Brief for Appee./ Cross Applt.	
____ Reply B. for Applt./ Cross Appee.	
1-20-84 Reply B. for Applt. MS 1-20-84 (10cc)	
____ Supp. B. for Applt.	
____ Supp. B. for Appee.	
12-7-83 Brief for Amicus MS 12-7-83 (SEC)	
____ Intervenor	
12-6-83 Appendix MS 12-6-83 (4cc-2 VOC.)	

EXTENSION Flg.	Motion for:	Ord Fld.	Ext. to:
____	Record List		
____	Transcripts		
____	Applt's. Brief		
____	Appee's. Brief		
____	Appee's. Brief		
____	Appee's. Brief		
____	Reply Brief		
____	Supp. Appendix		

SUMMARY OF EVENTS

ARGUED/~~SUBMITTED~~ 5/14/84

PANEL Gibbons, Hunter, C.J. & Rambo, D.J.

REARGUED

JUDGMENT-ORDER

OPINION 6/11/84 ☒ Signed ☐ ~~PCGxNxR~~ or Pub

MO Gibbons CO Hunter DO

JUDGMENT reversing and remanding to the said D.C. for further proceedings consistent w/the opinion of this Ct w/costs taxed against appellees, filed.

PET. FOR REHG.

☐ Denied ☐ Granted ☐ En Banc ☐ Panel

MANDATE STAYED TO: 8/1/84

MANDATE ISSUED

RECORD RETURNED

BILL OF COSTS 6/18/84 of Appellant

CERTIORARI FILED 7/27/84

☐ Denied ☒ Granted (ch)

11/13/84 S.C. # 84-165

Reported at 737 F2d 320 (84)

CONTINUATION (CAPTION/APPEARANCES):
SEE DOCKET ENTRIES ON PAGE TWO

Rosalind C. Cohen 4-23-84
Jacob H. Stillman 12-8-83
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549
FTS 272-2493
[Securities and Exchange Commission, amicus curaie.]

Robert J. Kelly 1-9-84
TOMPKINS, McGUIRE & WACHENFELD
550 Broad Street DISC.STMT 1-9-84
Newark, NJ 07102
201-622-3000
[Appellee Christopher J. O'Halloran]

[Appellee Christopher J. O'Halloran]

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

DOCKET NO. 83-5493

DATE	FILINGS—PROCEEDINGS
1983	
Aug. 8	Letter dated 8/4/83 from Frederick R. Dunne, Jr., Esq., counsel for appee Autobern Trading Corp., advising that they have been instructed by aplt. Ruefenacht, owner of stock of Auto. Corp., that he does not wish Autobern to be represented in this matter, etc., and therefore will not be filing anything w/the Ct., rec'd. Send to Merits Panel
Aug. 25	ORDER (Clerk) directed to Wm. Sokol, Official C.R., to Show Cause in writing, orig & 3 ccs by 9/4/83 why he should not be subject to sanctions for his/her delay in the prosecution of the appeal, filed. DISCHARGED 9/7/83
Sept. 6	Letter-Answer dated 8/30/83 from Wm. Sokol, Official C. Rep., in which he advises that the transcript which he was responsible for was filed in D.C. 8/30/83, in answer to Show Cause order of 8/25/83, filed.
Sept. 7	ORDER (Clerk) that upon consideration of letter-answer to Order to Show Cause, rec'd from Wm. Sokol, Official C.R., the Order to Show Cause of 8/25/83, be and hereby is DISCHARGED, filed.
Dec. 5	Letter dated 11/28/83 from James D. Opfer, Jr., Esq., cnsl for appee Ernest Stoecklin advising that he will bet be filing any brief on behalf of his client either in a positive way or in response to briefs filed by others, w/copy of letter from Stoecklin, rec'd. Send to Merits Panel

DATE	FILINGS—PROCEEDINGS
1984	
Jan. 11	Letter-joinder dated 1/9/84 from P.F. Pasternak, Esq., cnsl for appee David Bernstein advising that they will not submit a brief in this matter, but will join in any brief which may be submitted by other appees, rec'd. Send to Merits Panel
Jan. 12	Statement of aplee W. George Gould requesting oral argument purs to Rule 12(6) of Rules of U.S. Ct. of Appeals for Third Circuit, filed. Send to Merits Panel
Mar. 30	Letter dated 3/27/84 from Peter S. Pearlman, Esq., cnsl for aplt, pursuant to Rule 28(j), F.R.A.P., rec'd. for Ct's information.
Apr. 2	Motion by amicus curiae, The Securities and Exchange Commission, for leave to participate at oral argument, in which it requests to be allotted ten (10) minutes in which to present argument, filed.
Apr. 25	Order (*Gibbons*, Hunter, C.J. & Rambo, D.J.) granting above motion, filed.
Jun 27	Motion by Appellee, W. George Gould for a 30-day stay of the mandate, etc., filed. w/serv.
Jul 9	Partial Opposition of Appellant, Max A. Ruefenacht, to Appellee's motion for stay of mandate, w/service
Jul 27	Copy of Petition for a writ of cert. received from printer on behalf of counsel for Gould, received.

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civil Action No.
80-4097

MAX A. RUEFENACHT,

Plaintiff,

-VS-

CHRISTOPHER J. O'HALLORAN, JOACHIM K. BIRKLE, CONTINENTAL IMPORT & EXPORT, INC., AND W. GEORGE GOULD,

Defendants.

AND

CHRISTOPHER J. O'HALLORAN,

Third-Party Plaintiff,

-VS-

W. GEORGE GOULD,

Third-Party Defendant.

Honorable H. Lee Sarokin

AMENDED COMPLAINT AND JURY DEMAND

Plaintiff, MAX A. RUEFENACHT, residing at 25 Buckley Hill Road, Morristown, Morris County, New Jersey, by and through his attorneys, COHN & LIFLAND, ESQS., complains of the defendants as follows:

JURISDICTION AND VENUE

1. Jurisdiction and venue of this court are founded upon Section 22 of the Securities Act of 1933 (hereinafter the 1933

Act), 15 U.S.C. § 77v and Section 27 of the Securities Exchange Act of 1934 (hereinafter the 1934 Act), 15 U.S.C. 78aa.

2. The claims herein arise pursuant Sections 12 and 17 of the 1983 Act and Section 10b of the 1934 Act and the Rules and Regulations of the Securities and Exchange Commission promulgated thereunder including Rule 10b-5 and under the common law of fraud, negligence, reckless and negligent misrepresentation and breach of fiduciary duty.

3. Many of the acts and the conduct, combination and conspiracy charged herein, including the preparation of false and misleading financial statements, prospectuses and the issuance and dissemination of financial information to the investing public in general and this plaintiff in particular occurred in the District of New Jersey.

4. In connection with the acts, conduct, combination and conspiracy alleged in this compliant the defendants, directly and, indirectly, used the means and instrumentalities of interstate commerce including the mails and interstate telephone communications.

PARTIES

5. The nature and identify of the parties set forth in the caption of the complaint are as follows:

A. The plaintiff, MAX A. RUEFENACHT, is and was at all times relevant hereto a resident of the State of New Jersey. He is presently the owner of two thousand five hundred (2500) shares of common stock of Continental Import & Export, Inc., which represents fifty (50%) percent of the issued and outstanding common stock of that corporation. The plaintiff purchased that stock from the defendant, Continental Import & Export, in July of 1980.

B. The defendant, CONTINENTAL IMPORT & EXPORT, INC., (hereinafter Continental), is a corporation incorporated under the laws of the State of New Jersey maintaining its principal offices at 55 Morris Avenue, Springfield, New

Jersey 07081. Continental has authorized capital stock as follows: ten thousand (10,000) shares of common stock with no par value and ten thousand (10,000) shares of preferred stock with no par value. Five thousand (5000) shares of common stock of Continental have been issued and are outstanding. They are owned by the following persons in the following amounts:

Name	NUMBER OF SHARES OF COMMON STOCK
Lenzenhof GmbH	1,250 shares
Joachim K. Birkle	1,225 shares
Elisabeth Birkle	25 shares
Max A. Ruefenacht	2,500 shares

To the best of plaintiff's knowledge no preferred stock has been issued.

C. The defendant, JOACHIM K. BIRKLE, (hereinafter Birkle), is and at all times in question has been a resident of the State of New Jersey residing at 247 Underhill Road, South Orange, New Jersey 07079. At all times relevant hereto Birkle was the President, Chief Operating Officer and director of Continental and as such had full knowledge and control of the financial affairs of that corporation. Prior to the plaintiff's purchase of two thousand five hundred (2500) shares of common stock of Continental as set forth in paragraph 5A above, Birkle owned 1225 shares (49%) of Continental, Lenzenhof GmbH, a German corporation of which Birkle had complete operating control, owned 1250 shares (50%) of Continental and Birkle's wife, Elisabeth Birkle, owned 25 shares (1%) of Continental. That shareholding has continued down to the present as a result of which Birkle presently owns or controls directly and indirectly fifty (50%) percent of the outstanding shares of stock of Continental.

D. The defendant, CHRISTOPHER J. O'HALLORAN, (hereinafter O'Halloran), is and at all times in question has been a resident of the State of New Jersey and a licensed certified public accountant practicing the profession of public

accountancy at his offices located at the Valley Park Professional Center, 2517 Route 35, Building E, Wall Township, New Jersey 08736. In his capacity as a certified public accountant O'Halloran has at all times relevant hereto performed all of the accounting work for Continental and did prepare various financial statements for and on behalf of Continental at Birkle's request including, but not limited to, the financial statements complained of herein.

E. The defendant, W. GEORGE GOULD (hereinafter GOULD), is and at all times in question has been a resident of the State of New Jersey and an attorney at law licensed to practice in that state, maintaining his professional offices at 64A White Street, Red Bank, New Jersey. At the times at which various of the wrongful acts alleged herein occurred GOULD was the corporate counsel, an agent and a director of CONTINENTAL.

FIRST CAUSE OF ACTION AGAINST ALL OF THE DEFENDANTS PREDICATED ON VIOLATION OF SECTION 12(1) OF THE 1933 ACT 15 U.S.C. SECTION 771(1)

6. The plaintiff incorporates herein by reference as though recited verbatim and at length all of the allegations of paragraphs 1 through 5 of the complaint.

7. In and before July of 1980 the defendants did offer and solicit through means and instrumentalities of interstate commence [sic] including the mails and telephone the sale of certain securities specifically shares of stock (hereinafter securities) in Continental. Said offers were made through various items of correspondence and telephonic communications conducted by the individual defendants and intermediaries on their behalf with the plaintiff. The offers so made constitute an "offer to sell a security" as defined by Section 2(3) of the 1933 Act (15 U.S.C. § 77b(3)). The defendants further transmitted offers to sell and prospectuses including financial statements, through means and instrumentalities of interstate commerce.

8. The plaintiff alleges that at the time of the offer to sell the securities there was no registration statement in effect as to the securities all as required by Section 5 of the 1933 Act (15 U.S.C. § 77e). Hence, the sale of the securities by the defendants to the plaintiff violated Section 5 of the 1933 Act.

9. In reliance upon various representations made by the defendants in the prospectuses and otherwise the plaintiff did purchase the securities from Continental. In furtherance of that purchase the plaintiff did advance the sum of One Hundred Twenty Thousand ($120,000) Dollars in cash to the defendants, Continental and Birkle.

10. The plaintiff has made a demand upon the defendants for recision of the purchase of the securities including the return of the consideration paid pursuant to Section 12 of the 1933 Act and has offered to tender and has tendered his securities in connection therewith, however, the defendants have refused and declined to rescind the transaction.

WHEREFORE, plaintiff, MAX A. RUEFENACHT, demands judgment against the defendants, CHRISTOPHER O'HALLORAN, JOACHIM K. BIRKLE, W. GEORGE GOULD and CONTINENTAL IMPORT & EXPORT, INC., on the First Cause of Action as follows:

A. Restoring to the plaintiff the consideration paid for the securities with interest thereon less any amount of any income received thereon pursuant to Section 12 of the Securities Act of 1933, 15 U.S.C. § 771.

B. Costs of suit incurred including reasonable attorney's fees, expert's fees, disbursements and such costs as may be taxed by the Clerk of the Court.

C. Such other and further relief as the Court may deem just in the premises.

SECOND CAUSE OF ACTION AGAINST ALL OF THE DEFENDANTS PREDICATED UPON VIOLATION OF SECTION 12(2) OF THE SECURITIES ACT OF 1933, 15 U.S.C. § 771(2)

11. Plaintiff incorporates herein by reference as though recited verbatim and at length all of the allegations of paragraphs 1 through 5 and 7 through 10 of the complaint.

12. Continental with the aid, assistance and cooperation of Birkle, Gould and O'Halloran did solicit the sale of, offer to sell and, in fact, did sell two thousand five hundred (2500) shares of its common stock (the securities) to the plaintiff on or about July 1, 1980 by the use and means and instruments of transportation and/or communications in interstate commerce and/or of the mails by means of prospectuses and/or oral communications which included untrue statements of material facts and/or omitted to state material facts necessary in order to make the statements in the light of the circumstances under which they were made not misleading.

A. Specifically, by way of example only and not by way of limitation, the plaintiff alleges that the defendants did make the following material misrepresentations of fact to him:

i. The defendants represented that Continental had substantial and valuable assets including, but not limited to, good will primarily consisting of licenses worth $250,000 and certain import contract rights worth $400,000.

ii. The defendants represented that Continental did have a surplus in excess of par value of $650,000.

iii. The defendants did represent that Continental had a total equity of § 792,917.

iv. The representations referred to in paragraph 12 sub-paragraphs i, ii and iii above were made by the defendants in a financial statement prepared by the defendant O'Halloran on February 6, 1980 which purported to represent the financial position of Continental at December 31, 1979. The information for that financial statement emanated from Continental and the three individual defendants. The statement was prepared on behalf of and at the solicitation of Continental.

v. The statements aforesaid were repeated in substance in a financial statement prepared on September 29, 1980 purporting to represent the financial condition of Continental at July 31, 1980 wherein it was stated that Continental's good will and licenses had a value of $250,000, its import contract rights

had a value of $400,000, that its surplus from valuation of contracts and licenses was $650,000 and that the corporation had a total equity of $968,946. This latter financial statement was prepared by the defendant O'Halloran with the help, aid and solicitation of the defendants, Continental, Gould and Birkle.

vi. The defendants represented that Continental was negotiating contracts for nationwide distribution with two major firms and that there were distributors in various states interested in distribution rights for their areas.

vii. The defendants represented that sales for the first twelve (12) months of a nationwide distribution scheme beginning July 1980 would be $6,186,000 yielding a gross profit of $2,550,000 and a net profit of $848,000.

viii. The defendants represented that a sales program concentrating on the New York - New Jersey Metropolitan area would yield a rewarding return on the investment made and that the sales in such a plan for twelve (12) months beginning July 1, 1980 would be $5,326,000 yielding a gross profit of $3,018,500 and a net profit of $1,197,000.

ix. The defendants represented that the sales of Continental would increase by at least ten (10%) percent in the second year of operation over and above those projections set forth in sub-paragraphs vii and viii above.

x. The representations in sub-paragraphs vi through ix above were confirmed in a prospectus dated April 15, 1980 prepared by or with the aid and directions of the defendants Birkle, Gould and O'Halloran for and on behalf of Continental.

xi. The defendants represented that Birkle was a successful, sophisticated, and experienced businessman.

B. In fact:

i. Continental did not have good will or licenses worth $250,000 but rather, the licenses were worth approximately $7000.

ii. Continental did not have import or contract rights worth $400,000 but rather, had no substantial import or contract rights.

iii. Continental did not, in fact, have a surplus but in actuality maintained a deficit and was running at an increasingly large deficit.

iv. Continental was not seriously negotiating contracts for nationwide distribution with two major firms nor were there distributors in various states seriously interested in distribution rights for their areas nor did it have any reasonable expectation that it would be able to establish such a distribution network in the foreseeable future.

v. Continental could not reasonably foresee sales on [sic] profits to the extent projected in the prospectus dated April 15, 1980.

vi. Birkle had been involved in numerous business failures and/or insolvencies in the past with other business.

vii. The sales programs outlined could not progress as represented and would not and could not reasonably be expected to yield the gross sales or the profitability projected. All of which the defendants knew or in the exercise of reasonable care should have know.

C. Specifically by way of example only but not by way of limitation the plaintiff alleges that the defendants omitted to state the following material facts to the plaintiff:

i. That Continental had a net deficit rather than a positive equity.

ii. The good will and licenses of Continental had a minimal value at best and not a value which approached that reflected in the financial statements given.

iii. That Continental had no or very minimal contract rights which rights were not of a value which approached that reflected in the financial statements given.

iv. That Continental had no material contacts with distributors in the United States and would not be able to establish a distribution network as outlined in the foreseeable future.

v. That Continental could not attain the sales figures set forth in the prospectus of April 15, 1980.

vi. That Continental would need available financing or credit of not less than $3,000,000 to purchase the inventory needed to meet the sales projections in the prospectus of April 15, 1980.

vii. That Continental had no access to adequate financing to acquire the inventory needed to make the sales and meet the projections in the prospectus of April 15, 1980.

viii. That Birkle had been involved in numerous business failures and/or insolvencies in the past with other entities.

D. The misstatements and omissions referred to above were material in that had the true facts been stated the plaintiff would not have purchased the securities.

13. The plaintiff did rely upon the misstatements and was misled by the omissions set forth above in connection with and as a material part of his decision to purchase the securities.

14. The plaintiff has made a demand upon Continental for the recision of the purchase of the securities including the return of the consideration paid and has offered to tender and has tendered his securities in connection therewith, however, the defendants have refused and declined to rescind the transaction.

WHEREFORE, plaintiff, MAX A. RUEFENACHT, demands judgment against the defendants, CHRISTOPHER O'HALLORAN, JOACHIM K. BIRKLE, W. GEORGE GOULD and CONTINENTAL IMPORT & EXPORT, INC., on the Second Cause of Action as follows:

A. Restoring to the plaintiff the consideration paid for the securities with interest thereon less any amount of any income received thereon pursuant to Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(2).

B. Costs of suit incurred including reasonable attorney's fees, expert's fees, disbursements and such costs as may be taxed by the Clerk of the Court.

C. Such other and further relief as the Court may deem just in the premises.

THIRD CAUSE OF ACTION AGAINST ALL OF THE DEFENDANTS UNDER SECTION 17(a) OF THE 1933 ACT, 15 U.S.C. 77q(a) SECTION 10b OF THE 1934 ACT, 15 U.S.C. 78j(b) AND RULE 10b-5 PROMULGATED THEREUNDER

15. Plaintiff incorporates herein by reference as though recited verbatim and at length all of the allegations of paragraphs 1 through 5, 7 through 10, and 12 through 14 of the complaint.

16. The plaintiff alleges that the defendants and each of them by their conduct did offer for sale and sell to him securities by the use and means of instruments of transportation or communication in interstate commerce and/or by the use of the mails and did directly and indirectly:

A. Employ devices, schemes and artifices to defraud; and/or

B. Did obtain money and property by means of untrue statements of material fact and/or omissions to state material facts necessary in order to make the statements made in the light of the circumstances under which they were made not misleading; and/or

C. Did engage in transactions, practices and/or courses of business which operated and tended to operate as a fraud and/or deceit upon the plaintiff.

17. All of the defendants herein knew of and/or were on notice of and/or recklessly disregarded the facts indicating the material and misleading nature of each statement described in paragraph 12 and all sub-parts thereof and each defendant herein either issued, participated in the issuance of or aided and abetted the issuance of each of the aforesaid statements as follows:

A. Birkle as the sole operating officer and director and the managing employee of Continental participated in and knew of the true nature of the operations, statements of assets, status of contracts and licenses and all other misleading characteristics of the misleading statements and failures to state material facts alleged in paragraph 12 and all sub-parts thereof and knew of and/or recklessly disregarded the impact of those items on the value of the securities offered for sale and sold to the plaintiff and also knew of and/or recklessly disregarded the facts which showed that the financial statements and other prospectuses and documents given to the plaintiff were materially misleading. His knowledge and conduct are imputed to Continental on whose behalf, *inter alia*, he acted.

B. O'Halloran knew of the true nature of the operations, statements of assets and earnings and the other misleading charactistics of the misleading statements and failures to state material facts alleged in paragraph 12 and all sub-parts thereof and knew of and/or recklessly disregarded the impact of these items on the value of the securities offered for sale and sold to the plaintiff and participated in the formation and preparation of financial statements and other prospectuses which were materially misleading. Further, the defendant O'Halloran did deliberately and/or recklessly ignore and violate various sections of the Statement on Standards for Accounting and Review Service issued by the American Institute of Certified Public Accountants specifically among others statement 1 "Compilation and Review of Financial Statements" which provides, *inter alia:*

"7. The accountant should not submit unaudited financial statements of a non-public entity to his client or others unless as a minimum he complies with the provisions of this statement applicable to a compilation engagement. This precludes the accountant from merely typing or reproducing financial statements as an accommodation to his client."

The paragraphs dealing with compilation of financial statements provide, *inter alia*, the following standards:

A. Standard 10: The accountant must possess or acquire sufficient knowledge of the industry in which he prepares financial statements so as to prepare statements appropriate to that industry.

B. Standard 11: The accountant must possess a general understanding of the nature of the entities business and its business transactions and the form of its accounting records, *inter alia*, to determine whether it is necessary to perform other accounting services in order to prepare a proper financial statement.

C. Standard 12: If the accountant acquires information which should reasonably lead him to believe that the information supplied to him may be incomplete or inaccurate he must solicit further information from management and if they refuse to supply it to him he must withdraw from the engagement. Gould as corporate counsel and director of Continental participated in and knew of the true nature of the operations, statements of assets, status of contracts and licenses and all other misleading characteristics of the misleading statements and failures to state material facts alleged in Paragraph 12 and all sub-parts thereof and knew of and/or recklessly disregarded the impact of those items on the value of the securities offered for sale and sold to the plaintiff and also knew of and/or recklessly disregarded the facts which showed that the financial statements and other prospectuses and documents given to the plaintiff were materially misleading. His knowledge and conduct are imputed to Continental on whose behalf, *inter alia*, he acted.

D. Standard 13: Before issuing a report the accountant should make certain that that report is free from obvious material errors including inadequate disclosure.

E. Standard 14: The financial statement compiled without audit should state, *inter alia*, that the compilation is limited to presenting information which is the representation of management (owners).

F. Standard 19: When management requests that the accountant compile financial statements which omit substantially all disclosures or some disclosures required by generally accepted accounting principles the accountant must relate that fact in his report.

G. Standards 39-41: If the accountant becomes aware of departures from generally accepted accounting principles he should in addition to the provisions of Standard 19 disclose the departure and the effects of the departure if known and if not known to state that management has made no determination of the effects of the departure. If the modifications above are adequate to indicate the deficiencies the accountant should withdraw from the engagement.

18. Further, all of the defendants knew and intended and/or recklessly disregarded that the aforesaid acts and practices and misleading statements and omissions would materially affect the value of the securities of Continental and undertook said conduct knowing and intending that the plaintiff rely upon the truthfulness and accuracy of the representations made.

19. At the time the plaintiff purchased the securities he did not know and had no reason to believe that the representations provided to him and referred to in paragraph 12 and all subparts thereof contained untrue statements of material fact and/or material omissions.

20. Plaintiff purchased the securities in reliance upon the false and misleading statements of fact and because of his lack of knowledge of the material omissions.

21. The facts now complained of were material to the investment decisions of the plaintiff. Plaintiff is now aware that the value of his investment is substantially less than that which he was led to believe by the defendants and he has suffered substantial damage as a result of the wrongs complained of herein and his detrimental reliance thereupon.

WHEREFORE, plaintiff, MAX A. RUEFENACHT, demands judgment against the defendants, CHRISTOPHER O'HALLORAN, JOACHIM K. BIRKLE, W. GEORGE GOULD and CONTINENTAL IMPORT & EXPORT, INC., on the Third Cause of Action as follows:

A. Compensatory damages.

B. Costs of suit incurred including reasonable attorney's fees, expert's fees, disbursements and such other costs as may be taxed by the Clerk of the Court.

C. Such other and further relief as the Court may deem just in the premises.

FOURTH CAUSE OF ACTION AGAINST ALL OF THE DEFENDANTS FOR DAMAGES PREDICATED ON COMMON LAW FRAUD OR RECKLESS MISREPRESENTATIONS

22. The plaintiff incorporates herein by reference as though recited verbatim and at length all of the allegations of paragraphs 1 through 5, 7 through 10, 12 through 14, and 16 through 21 of the complaint.

23. The defendants did make the misrepresentations to the plaintiff and omit to state material facts willfully, deliberately, maliciously and with the intent that the plaintiff rely thereon in connection with his purchase of securities from the defendants; the plaintiff did, in fact, rely upon the material misrepresentations and/or omissions and in reliance thereon did make his

purchase from Continental as a result of which he has sustained substantial damage to his great detriment.

24. The plaintiff alleges that the defendants' statements were made knowingly, willfully, recklessly or intentionally and in wanton and reckless disregard of the rights of the plaintiff.

WHEREFORE, plaintiff, MAX A. RUEFENACHT, demands judgment against the defendants, CHRISTOPHER O'HALLORAN, JOACHIM K. BIRKLE, W. GEORGE GOULD and CONTINENTAL IMPORT & EXPORT, INC., on the Fourth Cause of Action as follows:

A. Compensatory damages.

B. Punitive damages.

C. Costs of suit incurred including reasonable attorney's fees, expert's fees, disbursements and such other costs as may be taxed by the Clerk of the Court.

D. Such other and further relief as the Court may deem just in the premises.

FIFTH CAUSE OF ACTION FOR RECISION ETC., PREDICATED UPON COMMON LAW, FRAUD OR RECKLESS MISREPRESENTATIONS AGAINST ALL OF THE DEFENDANTS

25. Plaintiff incorporates herein by reference as though recited verbatim and at length all of the allegations of paragraphs 1 through 5, 7 through 10, 12 through 14, 16 through 21, and 23 through 24 of the complaint.

26. The plaintiff has tendered his securities to the defendants, Continental, Gould and Birkle, and has offered to rescind the sale of the securities which tender and offer has been refused by the defendants.

WHEREFORE, plaintiff, MAX A. RUEFENACHT, demands judgment against the defendants, CHRISTOPHER O'HALLORAN, JOACHIM K. BIRKLE, W. GEORGE

GOULD and CONTINENTAL IMPORT & EXPORT, INC., in the Fifth Cause of Action as follows:

A. Granting to him recision of the purchase of the securities and restoring to him all consideration paid for the securities together with interest thereon.

B. Costs of suit incurred including reasonable attorney's fees, expert's fees, disbursements and such costs as may be taxed by the Clerk of the Court.

C. Such other and further relief as the Court may deem just in the premises.

SIXTH CAUSE OF ACTION AGAINST ALL OF THE DEFENDANTS PREDICATED ON COMMON LAW NEGLIGENCE AND NEGLIGENT MISREPRESENTATION

27. Plaintiff incorporates herein by reference as though recited verbatim and at length all of the allegations of paragraphs 1 through 5, 7 through 10, 12 through 14, 16 through 21, 23 through 24, and 26 of the complaint.

28. In the event that the conduct referred to above are not found to have been deliberate, willfull, wanton and/or reckless, the plaintiff contends that the wrongful acts of the defendants as alleged above and the misrepresentations made by them were grossly negligent and/or negligent. Specifically, but not by way of limitation, the plaintiff states that the defendants did commit the following negligent acts:

A. Continental and Birkle Did Negligently:

i. Misrepresent the good will and licensing value of Continental Import & Export, Inc.

ii. Misrepresent the import contract rights of Continental.

iii. Misrepresent the surplus in excess of par value of Continental.

iv. Misrepresent the total equity of Continental.

v. Misrepresent the financial viability of Continental and its value as an investment to the plaintiff.

vi. Misrepresent the status of their negotiations and contacts with potential distributors.

vii. Misrepresent the future profitability of Continental.

viii. Misrepresent that Brikle [sic] was a successful, sophisticated and experienced businessman.

ix. They were in other ways negligent.

B. O'Halloran Did Negligently:

i. Misrepresent the good will and licensing value of Continental Import & Export, Inc.

ii. Misrepresent the import contract rights of Continental.

iii. Misrepresent the surplus in excess of par value of Continental.

iv. Misrepresent the total equity of Continental.

v. Misrepresent the financial viability of Continental and its value as an investment to the plaintiff.

vi. Misrepresent the status of the negotiations and contacts with distributors.

vii. Misrepresent the future profitability of Continental.

viii. Fail to perform in accordance with the standards applied to certified public accountants generally and particularly those licensed to practice public accountancy in the State of New Jersey including his violations of various Sections of the Statements On Standards For Accounting and Review Services issued by the American Institute of Certified Public Accountants as recited generally in paragraph 17B above.

ix. Fail to examine, uncover and discern the improper values applied to good will, licenses and import contract rights.

x. Fail to uncover and discern the fact that there were no or substantially no import contract rights and/or that the licenses and good will of Continental were of a materially lesser value than that which he represented in connection with the financial statements and prospectuses in which he participated.

xi. Fail to adequately disclaim his responsibilities in connection with the preparation of the financial statements and prospectuses in question and to advise that he had performed no investigation of the underlying facts supporting the financial statements and prospectuses in question.

xii. Failed to properly evaluate the contract rights and licenses and future profitability of Continental.

xiii. Failed to adequately investigate and familiarize himself with the industry, business, business affairs, records and transactions of Continental before preparing the financial statements and other prospectuses.

xiv. He was in other ways negligent in the performance of his professional duties.

xv. Failed to state that Continental did not have the financial capacity to meet the projections made in the financial statements.

C. Gould Did Negligently:

i. Misrepresent the good will and licensing value of Continental.

ii. Misrepresent the import contract rights of Continental.

iii. Misrepresent the surplus in excess of par value of Continental.

iv. Misrepresent the total equity of Continental.

v. Misrepresent the financial viability of Continental and its value as an investment to the plaintiff.

vi. Misrepresent the status of the negotiations and contracts with distributors.

vii. Misrepresent the future profitability of Continental.

viii. Misrepresent that he possessed special knowledge of the alcoholic beverage industry.

ix. Misrepresent that Birkle was a successful, sophisticated and experienced businessman.

x. Failed to state that Continental did not have the financial capacity to meet the projections made in the prospectuses and financial statements.

xi. Failed to examine so as to ascertain and to uncover or discern, the fact that there were no or substantially no import contract rights and/or that the licenses and good will of Continental were of a materially lesser value than the value applied to those assets in the financial statements and prospectuses in which he participated and as a part of other representations made to the plaintiff concerning the financial condition of Continental and the value of an investment in the company.

xii. Failed to properly evaluate the contract rights, licenses and future profitability of Continental.

xiii. Failed to adequately investigate and familiarize himself with the industry, business, business affairs, records and transactions of Continental before submitting to O'Halloran the information upon which the financial statements and prospectuses were based and before other representations were made to the plaintiff concerning the financial condition of Continental and the value of an investment in the company.

xiv. Failed to provide O'Halloran with notice of deficiencies in the substance and method of compilation of the informa-

tion upon which the financial statements and prospectuses were based.

xv. He was in other ways negligent.

29. By virtue of the foregoing the plaintiff has been injured and is entitled to relief against the defendants and each of them.

WHEREFORE, plaintiff, MAX A. RUEFENACHT, demands judgment against the defendants, CHRISTOPHER O'HALLORAN, JOACHIM K. BIRKLE, W. GEORGE GOULD and CONTINENTAL IMPORT & EXPORT, INC., on the Sixth Cause of Action as follows:

A. Compensatory damages.

B. Costs of suit incurred including reasonable attorney's fees, expert's fees, disbursements and such costs as may be taxed by the Clerk of the Court.

C. Such other and further relief as the Court may deem just in the premises.

SEVENTH CAUSE OF ACTION PREDICATED UPON BREACH OF FIDUCIARY DUTY AND WASTE AGAINST DEFENDANTS, BIRKLE AND GOULD

30. Plaintiff incorporates herein by reference as though recited verbatim and at length all of the allegations of paragraphs 1 through 5, 7 through 10, 12 through 14, 16 through 21, 23 through 24, 26 and 28 through 29 of the complaint.

31. The plaintiff asserts that as a director, president and chief operating officer of Continental the defendant Birkle assumed a fiduciary duty to his co-shareholders including the plaintiff to act in a fair, evenhanded and just fashion toward them in his dealings with Continental and to concern himself above all with the welfare of Continental and not to abuse his position of dominance for his own gain or otherwise.

32. In fact the defendant Birkle did violate the fiduciary duty which reposed upon him, *inter alia*, by:

A. Refusing to make books, records and other documents of the corporation available to the plaintiff; and

B. Wasting corporate assets by using the funds of Continental for the purchase or payment of personal items for himself or other shareholders.

33. The plaintiff asserts that as a director and corporate counsel of Continental the defendant Gould assumed a fiduciary duty to the co-shareholders including the plaintiff to act in a fair, evenhanded and just fashion toward them in his dealings with Continental and to concern himself above all with the welfare of Continental and not to abuse his position of dominance for his own gain or otherwise.

34. In fact the defendant Gould as an agent and director of Continental did violate the fiduciary duty which reposed upon him, *inter alia*, by:

A. Refusing to make books, records and other documents of the corporation available to the plaintiff; and

B. Negligently attended to the affairs of Continental and/or knowingly and/or intentionally and/or recklessly misrepresented Continental's financial condition.

35. Plaintiff asserts that the conduct of the defendants, Birkle and Gould, as aforesaid was done willfully, maliciously and/or recklessly at the expense of the plaintiff.

36. As a result of the foregoing the plaintiff has been injured and is entitled to relief against the defendants, Birkle and Gould.

WHEREFORE, plaintiff, MAX A. RUEFENACHT, demands judgment against the defendants, JOACHIM K. BIRKLE and W. GEORGE GOULD, on the Seventh Cause of Action as follows:

A. Compensatory damages.

B. Punitive damages.

C. Costs of suit incurred including reasonable attorney's fees, expert fees, disbursements and such costs as may be taxed by the Clerk of the Court.

D. Such other and further relief as the Court may deem just in the premises.

DEMAND FOR TRIAL BY JURY

Plaintiff, MAX A. RUEFENACHT, herewith demands trial by jury of six persons on all issues so triable.

COHN & LIFLAND, ESQS.
PETER S. PEARLMAN, ESQ.
JEFFREY W. HERRMANN, ESQ.
Attorneys for Plaintiff

By:_____
PETER S. PEARLMAN
A Member of the Firm

DATED: November 20, 1981

THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civil Action No.
80-4097

MAX RUEFENACHT,
Plaintiff,

-V-

CHRISTOPHER O'HALLORAN, ET AL,
Defendants.

(BENCH OPINION)

April 21, 1982
Newark, New Jersey

BEFORE: The Honorable H. Lee Sarokin, U.S.D.J.

WILLIAM SOKOL, C. S. R.
Official Court Reporter

THE COURT: Motion of Defendants for Summary Judgment.

Plaintiff Max Ruefenacht has brought this action under the federal securities laws, citing provisions in both the 1933 and 1934 Acts. He has named as defendants Continental Import & Export, Inc., a beverage importer, Joachim Birkle, the president of Continental, Christopher O'Halloran, a Certified Public Accountant who did some work for Continental, and W.

George Gould, a director of and corporate counsel to Continental. Defendant Gould now moves for summary judgment on the basis that the transactions sued upon did not involve "securities" as defined by federal law, and therefore there is no jurisdiction under the federal securities statutes. The other defendants join in the motion. In addition, if the federal claims are dismissed defendants request that the Court not exercise its pendant jurisdiction over the plaintiff's State law claims, and dismiss those also.

The amended complaint alleges that in early 1980 Birkle offered to sell stock in Continental to Ruefenacht, and pursuant to this offer provided various financial forms to Ruefenacht. At that time Continental was owned 49% by Birkle, 50% by Lenzenhof GmbH, a German company controlled by Birkle, and 1% by Birkle's wife. Plaintiff alleges that in reliance on the financial documents and other oral representations of defendants, he agreed to purchase 2500 shares of stock for $250,000. This was to represent 50% of Continental, and no other person was to own more than 25%. Plaintiff has stated in deposition testimony that this price was in consideration of his promise to devote certain of his time, efforts and talents to Continental's business.

In fact, plaintiff did undertake a trip to Europe on behalf of Continental in pursuit of contracts to import beverages. This trip was moderately successful, and at that time it was thought that several contracts would be signed as a result of the trip. Ruefenacht was later involved in meetings resulting from his trip, between Continental and the firms he had contacted in Europe. Ruefenacht was also involved in the hiring of a national sales manager for Continental, expressing his views on an appropriate level of compensation. He claims that his participation contributed to the eventual contract, but that he had no real input into the final form. He states that he was only informed of the final form after it was signed.

In the course of his relationship with Continental, Ruefenacht signed a bank signatory card designating himself

to be the company's vice-president and treasurer. At his deposition he claimed that these designations were for the checks only, and that he was supposed to become Chairman of the Board. In any case, he claims that he never did sign any checks for Continental. Plaintiff also applied for and received a State solicitor's permit, representing under oath that on behalf of Continental he would sell various alcoholic beverages to retailers and wholesalers, and that he would be compensated by a salary, expenses and a percentage.

After Ruefenacht had paid $120,000 toward his total of $250,000, he began to suspect the accuracy of the financial data he had been given previously. At this point he refused to pay the remaining $130,000, and to this date his total investment remains $120,000. Having confirmed his suspicions to his own satisfaction, Ruefenacht filed this suit for fraud in connection with the sale of the 50% interest to him.

The Securities Act of 1933 provides:

When used in this title, unless the context otherwise requires—

(1) The term "security" means any note, stock, . . . 15 U.S.C. Section 77b. The 1934 Act contains a similar definition at 15 U.S.C. Section 78c(a) (10). Defendants contend that the transaction in the instant case did not involve the sale of a "security", as interpreted by the Supreme Court in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) and *SEC V. W.J. Howey Co.*, 328 U.S. 293 (1946).

There can be no real dispute in this case that the transaction involved stock. Defendant attempts to argue that because Continental is a closed corporation and its stock has certain limitations common to such corporations, that stock is by definition not a security. This is clearly not the case, since the Courts have consistently included closed corporations within the purview of the securities laws. See, e.g., *Thomas v. Duralite Co.*, 524 F. 2d 577 (3d Cir. 1975); *Bronstein v. Bronstein*, 407 F. Supp. 925, 931 (E.D. Pa. 1976), and cases cited therein. There-

fore defendants' contention must be based on the clause "unless the context otherwise requires," since on its face the statute clearly includes "stock" within its definition.

The Supreme Court has held that to conclude a transaction involves securities, a Court must determine that "the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *SEC v. W.J. Howey Co.*, 328 U.S. at 301. See also *Forman*, 421 U.S. at 852.[1]

In *Forman* the Court promulgated an "economic reality" test, holding that regardless of the name given to a given transaction, the Court must investigate the realities of the situation to determine if securities were actually involved. To aid in ambiguous situations, the Court set out five "common features of stock" which could serve as a guide to identify a true security:

(1) the right to receive dividends contingent on profits;

(2) negotiability;

(3) ability to be pledged or hypothecated;

(4) voting rights in proportion to shares owned; and

(5) potential to appreciate in value.

See *Forman*, 421 U.S. at 851. In *Forman* an investment in a cooperative apartment house was found to lack these attributes, and in spite of the fact that the investment was characterized as "stock", the Court found that it was not a security. The Court has recently affirmed the use of this analysis, noting that "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, Sec. Reg. & Law. Rep. (BNA), Vol. 14

[1]The Ninth Circuit has held that for purposes of this test, "solely" means that the efforts of others must be "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *SEC v. Glenn W. Turner Enterprises*, 474 F. 2d 476, 482 (9th Cir.) cert. denied 414 U.S. 821 (1973). The Supreme Court has expressly reserved decision on this issue. *Forman*, 421 U.S. at 852 n.16.

p. 437, 438 (March 8, 1982). It is not entirely clear, however, that this test should be applied when the transaction involves what is traditionally known as "common stock."

The Fourth Circuit has held that "when a transaction involves stock, there is a strong presumption that the statutes apply." *Coffin v. Polishing Machines, Inc.*, 596 F. 2d 1202, 1204 (4th Cir. 1979). In *Coffin* the plaintiff had bought half the shares in Polishing Machines, Inc. and had moved to Virginia in order to devote his full time to duties as executive vice-president of the corporation. The Court noted that "(w)e do not believe that *Forman* denies a purchaser of ordinary corporate stock the protection of the federal securities laws simply because he intends to participate in the management of the corporation in which he invests." *Id.* The Court therefore held that although the transaction at issue could have been structured differently, when the parties elected to utilize a stock transfer they subjected themselves to the federal securities statutes. The *Coffin* approach has been adopted by at least three District Courts. *Bronstein v. Bronstein*, supra; *Titsch Printing Inc. v. Hastings*, 456 F. Supp. 445 (D. Colo. 1978); *Mifflin Energy Sources, Inc. v. Brooks*, 501 F. Supp. 334 (W.D. Pa. 1980).

However, several Courts have purported to reject the *Coffin* approach, and have applied the economic reality test to transactions involving traditional stock. See, e.g., *Canfield v. Rapp & Son, Inc.*, 654 F. 2d 459 (7th Cir. 1981); *Fredericksen v. Poloway*, 637 F. 2d 1147 (7th Cir. 1981); *Seagrave Corp. v. Vista Resources, Inc.*, Fed. Sec. L. Rep. (CCH) paragraph 98,469 (S.D.N.Y. February 24, 1982). In these cases, the Courts found that although the transactions nominally involved stock, the stock was actually peripheral to the main transaction, which was a transfer of control of a business. In all of the above cases 100% of the stock was sold, and in fact only one such case has been cited to the Court involving less than 100%. Even in that case 94.6% of the stock was transferred, and the Court noted that the buyer obtained "the right to exercise complete control over the day-to-day activities of the business." *Somogyi v. Butler*, 518 F. Supp. 970, 984 (D.N.J. 1981).

It is the fact that total control was transferred in the above cases that violated the *Howey* requirement that profits be generated primarily by the efforts of others. Thus, even though stock changed hands, the Courts concluded that the investment could succeed or fail on the efforts of the investor, and did not therefore qualify as a security. These cases can easily be reconciled with *Coffin*, since in the latter case only 50% of the stock was transferred and plaintiff did not have complete control over his investment. The heavy presumption mentioned in *Coffin* might be thought to be canceled by a showing that the investor is not so much interested in the stock as in the control of the business. Dealing with a situation admittedly far from normal common stock, the Supreme Court noted in *Weaver* that the buyers' power to "veto future loans gave them a measure of control over the operation of the slaughterhouse not characteristic of a security." 14 Sec. Reg. & Law. Rep. at 439.

In the present case the stock which Ruefenacht received contains all the attributes mentioned by the *Forman* Court as indicating that the transaction did involve a security. The crucial issue in this case, then, is the amount of control he gained over Continental. He did not have total control, owning only 50% of the stock, and he was not in control of the day-to-day activities, although he did participate in some of them. Although Ruefenacht contributed his talents and efforts to Continental's pursuit of business and profits, it has not been shown that this goal was to control the entire business. If he was not in overall control, the Court must conclude that the efforts of those who *were* running the business, such as Birkle, were to be the primary source of profits realized on Ruefenacht's investment. As such the investment would meet the test for a security, and the transaction would be governed by the federal laws. A hearing is necessary to resolve these questions. The Court will retain jurisdiction over both the federal and pended State claims, and defendants' motion is DENIED without prejudice to their right to renew upon the submission of all proofs.

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

Civil No.
80-4097

Hon. H. Lee Sarokin

MAX A. RUEFENACHT,

Plaintiff,

v.

CHRISTOPHER J. O'HALLORAN, JOACHIM K. BIRKLE, CONTINENTAL IMPORT & EXPORT, INC., AND W. GEORGE GOULD,

Defendants.

AND

W. GEORGE GOULD,

Third-Party Plaintiff,

v.

DAVID BERNSTEIN, AUTOBERN TRADING CO., INC., ERNEST STOECKLIN, LENZENHOF GMBH,

Third-Party Defendants.

REPORT AND RECOMMENDATION

Plaintiff, Max A. Ruefenacht, claims that this action is brought under the Securities Acts and there is thus federal question jurisdiction in this court. Defendants, on the contrary, claim there is no transaction involving a "security" and that this court therefore has no jurisdiction. A motion for summary judgment was brought on before Hon. H. Lee Sarokin and it was determined that the crucial question is how much control over the business plaintiff obtained by purchasing half of the stock of a corporation. The matter was referred

to the magistrate to conduct a factual hearing on the issue and report findings.

The evidentiary hearing commenced on June 24th and during the noon recess, the matter was reported settled. Unfortunately, the settlement agreement was not performed and the matter was restored. The evidentiary hearing recommenced on November 19, 1982, after which both parties submitted proposed findings.

There is no dispute that Max A Ruefenacht and defendant Joachim K. Birkle made an oral agreement whereby Ruefenacht would purchase 50% of the shares of stock in Continental Import & Export, Inc. The other 50% of the shares would be owned by Birkle, a German corporation with which he was affiliated, and Birkle's wife. The purchase price was $250,000.00 for the 2,500 shares, of which $120,00.00 was paid. It is also undisputed that Ruefenacht and Birkle intended to enter into a written stockholder's agreement, drafts of which had been prepared by counsel but remained unsigned.

Continental was engaged in the business of importing and distributing beer, wine and liquors (T:15-3). Ruefenacht's wife's family is engaged in the brewery business in Europe and one of the reasons for his interest in Continental was the prospect of importing the family beer. (T:24-15) Ruefenacht described himself as a wine lover with an admiration for California wines (T:28-23). He had no professional background in the industry (T:33-13) and considered himself an amateur (T:33-16). Ruefenacht had been engaged in business as an exporter of automobile spare parts and accessories from the United States and the import into the United States of used motor vehicles (T:34-8). His company is one of the third-party defendants, Autobern Trading Co., Inc., in which Ruefenacht is associated with another third-party defendant, David Bernstein.

In addition to his interest in wines and his occupational background in the importing and exporting of motor vehicles and parts, Ruefenacht is multi-lingual, being fluent in English, German, French and Italian (T:43-24). While Mr. Birkle also

speaks German (T:16-9), it was thought that Ruefenacht's fluency in French would assist in dealing with French wine producers (T:44-11).

Ruefenacht looked upon himself as a partner in the business with Birkle (T:63-22). He and Birkle were to share together the "top level decisions of the company" (T:64-10). He and Birkle were to share the decisions involving the capital structure of the corporation (T:64-12) and the introduction of new product lines (T:64-24). It was contemplated that other persons in the management of the company would also be involved in the decision making process (T:65-6). Between June or July to October, 1980 (T:17-8), the period during which Ruefenacht was associated with Continental, no such decisions were made (T:66-22).

Throughout the period in question, Ruefenacht remained a full time employee of his Autobern company (2T:164-9). It is not disputed that Birkle was the president of Continental. It was Rufenacht's intention that he would become chairman of the board (2T:160-10). Ruefenacht never attended any directors' meetings and none was ever held (2T:160-15). He did, however, sign a corporate resolution in a form supplied by the National State Bank (DG-3) in which he was designated as vice president and treasurer. The resolution was signed for the purpose of permitting Ruefenacht to sign corporate checks at a time when Birkle was leaving for a trip to France (2T:121-20). The action was taken at Birkle's request (2T:121-19) and was done while seated in a car in front of the bank (2T:122-14).

Ruefenacht disavowed any intent or any capacity to unilaterally assume control of the day to day business of Continental. It was intended that he receive a salary of approximately $24,000.00 annually (2T: 124-18). His participation in the affairs of the company during the few months involved bespeaks an intention to actively participate in the company's affairs. Mr. Weidli, an employee of Autobern, was taken on by Continental as office manager (2T:52-6). Weidli was a close friend of Ruefenacht and was residing with him at the time of

the hiring (2T:53-5). Ruefenacht's business partner in Autobern, Mr. Bernstein, was to be paid $500.00 weekly to handle the Continental books (2T:57-19). The other employees of Continental consisted of a secretary, who had apparently been with the company before Mr. Ruefenacht's association with it and two other persons who were selected by Birkle. Max Newman was hired as sales manager (2T:1712). Ruefenacht and Birkle discussed his hiring and the terms of his compensation (2T:19). It is not disputed that Birkle introduced Newman to Ruefenacht.

Larry Yaffa was engaged by Birkle without either the knowledge or approval of Ruefenacht as a professional advisor or consultant to Continental. Yaffa was paid on a daily basis and advised the company about the wine and liquor business (2T:46-20 to 47-23).

Ruefenacht participated in the business of Continental on a part time basis. During the summer of 1980 he travelled in France, Germany and Switzerland on his annual family holiday in Europe (T:61-9 to 63-23; 2T:162-8 to 21). During his vacation he called on four wine and spirit producers in the Alsace and southern Germany (T:61-8). He was acquainted with one of the companies because of his familiarity with his wife's family's brewery business (T:61-2). He apparently had with him a letter of introduction from Continental which he did not use (T:61-25). Although most of the producers were willing to continue talks, none of them ever came to the United States to pursue the contact (2T:61-11 to 65-2).

Ruefenacht participated with Birkle and Yaffa at luncheon meetings with approximately six French wine producers. The luncheons were generally at the Plaza Hotel in New York City. One was at the Metropolitan Club and one at the Moven Pick Restaurant in Hanover, New Jersey (2T:49-17 to 50-12). During these meetings Ruefenacht made use of his skill in French and translated for the non-French speaking participants written contracts which were being proffered to Continental by the French producers (2T:103-20 to 104-11). After lunch,

Ruefenacht would return to the Autobern office and Birkle would continue the discussions, later filling Rufenacht in about the progress of the conversation (2T:105). In addition to the luncheon meetings, Ruefenacht and Birkle met approximately two dozen times at the Autobern office (2T:51-6). Ruefenacht kept track of the daily business of Continental by means of his almost daily conversations with Mr. Weidli (2T:55) and his very frequent conversations with Birkle (2T:56-19).

Together with Birkle and the entire personnel of Continental, Ruefenacht participated in a dinner at the Moven Pick Restaurant in Hanover, given for the Swiss Soccer Club. The object of the dinner was to promote a German sparkling wine and to obtain the brand for distribution (2T:117 to 120; 180-7 to 18).

Ruefenacht's interest in the company business is further exemplified by his urging the company lawyer to use dispatch in securing government approval for a particular lable of wine (2T:175-13 to 20). At the request of Mr. Birkle, the company's lawyer revealed to Ruefenacht his recommendation on a proposed lease of a warehouse (2T:176-6 to 12). Ruefenacht had spent some time with Birkle visiting warehouses which were being considered for use by Continental (2T:69-13 to 71-13).

It was conceded by counsel for defendant Gould that the transaction between Ruefenacht and Birkle was to result in Ruefenacht's having something less than "total control" (2T:23-1) of Continental. It is further stipulated that Ruefenacht was to acquire 50% of the shares of the corporation. The remaining 50% of the shares would remain in another group of persons (2T:146-19). Counsel agreed that neither party to the transaction was in a position to take any action relative to the corporation without mutual consent of the other party (2T:149-23). Counsel agreed that in a deadlock situation either party had the power to veto a decision made by the other (2T:151-1 to 4). Counsel stated as follows at 2T:151-5 to 9):

> As a matter of fact, as I think the evidence has already shown, Mr. Ruefenacht and Mr. Birkle were jointly in-

volved in all of the decisions, major decisions, especially—that were occurring for Continental and that was how they envisioned the deal in the first place.

When asked to point out any particular action which Ruefenacht could take without Birkle going along, counsel replied, "I don't think there is anything" (2T:153-7). Counsel suggested that by failing to pay the balance of the agreed upon purchase price for the 2,500 shares, Ruefenacht was in effect controlling the finances of the corporation. It is respectfully suggested that this is a specious argument.

CONCLUSION

Based upon the foregoing findings of fact it is concluded that Ruefenacht intended to purchase a 50% ownership of the shares of stock of Continental and to exercise all that control to which a 50% owner is entitled. It has not been shown that there was any possible way that Ruefenacht could have exerted more control. His actions were at all times subject to the absolute veto of his partner, Mr. Birkle. The actions of the parties are consistent with equality of control and joint participation in the business of the corporation is clearly demonstrated by the evidence presented. There is no evidence to the contrary.

SERENA PERRETTI
United States Magistrate

Dated: January 31, 1983
ORIGINAL TO THE CLERK
xc: Hon. H. Lee Sarokin
All Counsel

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

Civil Action No.
80-4097

MAX A. RUEFENAUCHT,
Plaintiff,

VS

CHRISTOPHER J. O'HALLORAN, JOACHIM K. BIRKLE AND CONTINENTAL IMPORT & EXPORT INC.,
Defendants.

AND

CHRISTOPHER J. O'HALLORAN,
Third-Party Plaintiff,

VS

W. GEORGE GOULD,
Third-Party Defendant.

Newark, New Jersey
April 15, 1983

BEFORE: Honorable H. Lee Sarokin, U.S.D.J.

THE COURT: This matter comes before the court on a renewal of a summary judgment motion made by defendant W. George Gould. The facts of the case are summarized in this court's previous opinion on this motion; *Ruefenacht v. O'Halloran*, No. 80-4097 (D.N.J. April 21, 1982). Defendant Gould then moved for summary judgment dismissing the complaint for lack of federal jurisdiction.[1] Federal jurisdiction is based upon the federal securities laws. Defendant asserts that the transactions that are the basis of this suit did not involve

---

[1]The other defendants in the case joined in the motion.

"securities" as defined in the federal securities laws. Defendant moves to dismiss the federal claims for lack of jurisdiction and to dismiss the pendent state law claims as a matter of discretion.

In its previous opinion the court discussed a controversial point of law that has divided the federal courts of appeal. Briefly stated, the question is whether a transaction involving ordinary stock is necessarily a security transaction under the federal law. The definitions of "security" in the federal statutes literally include "stock", but they also contain the words, "unless the context otherwise requires." 15 U.S.C. Section 77b; 15 U.S.C. Section 78c(a)(10). The Supreme Court and lower courts have applied an "economic reality" test[2] to determine whether transactions involve "securities" within the meaning of the federal statutes[3], but the Supreme Court has never applied this test to a transaction involving ordinary stock. Several circuit courts of appeal have applied this test to ordinary stock transactions. *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981); *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982); *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Chandler v. Kew, Inc.*, 691 F.2d 443 (10th Cir. 1977). Two circuit courts of appeal have refused to apply the "economic reality" test to transactions involving ordinary stock, concluding that these transactions are literally within the definitions of "security". *Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202 (4th Cir. 1979), *cert. denied*, 444 U.S. 868 (1979), *Golden v. Garofalo*, 678 F.2d 1139 (2d Cir. 1982); *Seagrave Corp. v. Vista*

---

[2]"The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *S.E.C. v. Howey Co.*, 328 U.S. 293, 301 (1946).

[3]*United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975); *(S.E.C. v. Howey Co.*, 328 U.S. 293 (1946); *Marine Bank v. Weaver*, ——— U.S. ———, 102 S.Ct. 1220 (1982).

Resources, Inc., 696 F.2d 227 (2d Cir. 1982). The Third Circuit Court of Appeals has not yet ruled on this precise question.[4]

The court, in its previous opinion, determined that the "economic reality" test should be applied to transactions involving conventional stock to determine if they are entitled to the protection of the federal securities laws. The court characterized the crucial issue as "the amount of control" that plaintiff gained over the business whose stock was purchased (Continental Import & Export, Inc.). Slip. op. at 9. The court referred the matter to the Magistrate for a hearing, and denied the motion for summary judgment without prejudice to the right to renew upon completion of the hearing.

The court has received a Report and Recommendation from the Magistrate with detailed findings about the extent of control to be exercised by Mr. Ruefenacht in the business of Continental. Based on these findings, defendant Gould has renewed his motion for summary judgment.

The court has received objections to the Report and Recommendation from David Bernstein, a third-party defendant. Mr. Bernstein objects to the finding that Ruefenacht's "company is one of the third-party defendants, Autobern Trading Co., Inc., *in which Ruefenacht is associated with another third-party defendant, David Bernstein*" (emphasis added). Mr. Bernstein asserts that he was no longer associated with Mr. Ruefenacht or Autobern Trading Co., Inc., except as a shareholder in redemption, at the time of the transactions involved in this

---

[4]The court in *Golden* cited *Glick v. Campagna*, 613 F.2d 31 (3d Cir. 1979) as support for its position, at 678 F.2d 1142n.4. In *Glick* the court discussed the merits of regulating close corporations. 613 F.2d at 35n.3. This court has reviewed that decision and concludes that the court of appeals did not determine the precise question presented here. *Goodman v. DeAzoulay*, 554 F.Supp. 1029, 1034 (E.D.Pa 1983). Several other district courts in this circuit have applied the economic reality test to transactions involving stock since *Glick*. *Anchor-Darling Industries, Inc. v. Suozzo*, 510 F. Supp. 659 (E.D.Pa. 1981); *Somogyi v. Butler*, 518 F.Supp. 970 (D.N.J. 1981); *Pallastrone v. Blimpie Industries, Ltd.*, No. 79-3328 (E.D.Pa. Dec. 9, 1981).

case. In addition, Mr. Bernstein objects to the findings that he was a continuing business partner in Autobern, and that he was to be paid five hundred dollars per week to handle the books and records of Continental. The court concludes that these findings are not necessary to a determination of the jurisdictional issue before it. Having received no opposition to their deletion from any other party, the Court will adopt the Report and Recommendation without these findings as to Mr. Bernstein.

The conclusion of the Magistrate regarding the extent of control to be exercised by Mr. Reufenacht is as follows.

> Based upon the foregoing findings of fact it is concluded that Ruefenacht intended to purchase a 50% ownership of the shares of stock of Continental and to exercise all that control to which a 50% owner is entitled. It has not been shown that there was any possible way that Ruefenacht could have exerted more control. His actions were at all times subject to the absolute veto of his partner, Mr. Birkle. The actions of the parties are consistent with equality of control and joint participation in the business of the Corporation is clearly demonstrated by the evidence presented. There is no evidence to the contrary.

At oral argument on this renewed motion counsel for plaintiff once again urged the court to adopt the position that the "economic reality" test does not apply to transactions involving ordinary stock. The court has considered the arguments of counsel and the legal developments that have occurred since its original decision and concludes that its previous decision to the contrary should remain. The "economic reality" test should be applied to transactions involving ordinary stock to determine whether they involve securities within the meaning of the federal securities acts.

In applying this test to the facts of this case the crucial question is whether the profits were to come "solely from the efforts of others." The other parts of the test are satisfied here, for the transaction involved investment in a common enterprise

with an expectation of profits. The findings of the Magistrate indicate that Mr. Ruefenacht intended to exercise joint control of the business with Mr. Birkle; there would be "equality of control." Based on these findings the court concludes that the profits of the enterprise would not be derived "solely" or substantially from the efforts of others. Therefore, the transaction does not involve "securities" within the meaning of the federal securities acts.

The key to the application of the "economic reality" test to this case is that plaintiff was an active investor who intended to participate significantly in the management of the business. He was not a passive investor who relied on others to manage the business. "Not all sales transactions which involve 'stock' are necessarily covered by the securities laws. Rather, the test for coverage, in general is whether the purchaser is placing money in the hands of another who will control the funds and the business decisions." *Frederiksen*, 637 F.2d at 1148. The court in *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982), characterized this distinction as one between investors, who "rent capital to those who want to manage", and entrepeneurs, who "buy assets to manage." *Id.* at 202. Plaintiff here was acting as an entrepeneur, with an intent to jointly manage the business, rather than as a passive investor, who rented his capital to others who managed the business.

Although many of the cases relied upon by defendant involve a sale of virtually one hundred percent of a corporation's securities and assumption of complete control of the business,[5] the amount of the stock purchased is not the determining factor. The more important factor is how much control the plaintiff intended to exercise over his investment. "It is apparent that the approach used here is not a function of numbers. A sale of less than 100% of the stock might not be covered by the Acts. A sale of 100% of the stock can be covered by the Acts."

---

[5] *Frederiksen v. Poloway*, supra; *King v. Winkler*, supra; *Chandler v. Kew, Inc.*, supra; *Anchor-Darling Industries, Inc. v. Suozzo*, supra; *Somogyi v. Butler*, supra.

King, 673 F.2d at 346. In *Goodman*, 554 F.Supp. 1029, the court found that the purchaser of one-third of the stock of a corporation did not purchase "securities" within the meaning of the federal securities acts. The evidence indicated that the purchaser had "active control of her investment." *Id.* at 1035. The Seventh Circuit Court of Appeals has created a rebuttable presumption to be used in cases where a large block of stock, but not 100%, has been purchased. *Sutter v. Groen*, 687 F.2d at 203. If the purchaser acquires more than fifty percent of the common stock of the corporation "his purpose in purchasing the stock will be presumed to have been entrepeneurship rather than investment." *Id.*[6] In *Pallastrone v. Blimpie Industries, Ltd.*, No. 79-3328 (E.D.Pa. Dec. 9, 1981), the court found that purchasers of fifty percent of a company's stock had not purchased "securities." The court found that the "plaintiffs entered into the agreement with Figueroa for the purpose of purchasing a one-half interest in a business which they intended to operate and manage in conjunction with the defendant Figueroa . . ." Slip op. at 7.

The trend of the law is to apply the "economic reality" test to purchases of less than all of the company's stock to determine whether the purchaser would actively manage his investment. Because Mr. Reufenacht intended to jointly manage Continental with Mr. Birkle, he did not purchase "securities" as defined in the federal acts. Therefore, there is no jurisdiction to support the federal securities claims in the complaint. These claims are dismissed for lack of jurisdiction. There is no diversity of citizenship among the parties to support the pendent state law claims independently of the asserted basis for federal jurisdiction. The court, in its discretion, will dismiss these claims as well. *United Mine Workers v. Gibbs*, 383 U.S. 715 (1966).

---

[6]The court specifically did not consider the application of these principles to a purchase of fifty percent or less of a company's stock. *Id.*

NO. 84-165

IN THE

SUPREME COURT OF THE UNITED STATES

FEBRUARY TERM, 1985

W. GEORGE GOULD, PETITIONER

v.

MAX A. RUEFENACHT, et al.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR RESPONDENT, CHRISTOPHER J. O'HALLORAN

ROBERT J. KELLY, ESQ.
Tompkins, McGuire & Wachenfeld
Attorneys for Respondent,
CHRISTOPHER J. O'HALLORAN
550 Broad Street
Newark, NJ 07102
(201) 622-3000

INDEX

TABLE OF CITATIONS

Statutes and Rules

OPINIONS BELOW

The opinion of the Court of Appeals [Pet. App. A, 2a-43a] is reported at 737 F.2d 320 (3d Cir. 1984). The opinion of the District Court (App. at pp. 57a) is not reported.

JURISDICTION

The judgment of the Court of Appeals was entered on June 11, 1984. The petition for a writ of certiorari was filed on July 27, 1984 and was granted on November 13, 1984. The jurisdiction of this court rests upon 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether an individual can successfully maintain a cause of action pursuant to the Securities Act of 1933, 15 U.S.C. §77b(1) and the Securities Exchange Act of 1934, 15 U.S.C. §78c(a)(10) where the economic reality of the transaction, albeit denominated by the parties as a transfer of "stock," reveals that the purchaser did not expect to derive profit solely from the efforts of others.

STATEMENT

Continental Import & Export, Inc. is a company engaged in importing wines and spirits. Joachim Birkle is the president of Continental and owned or controlled 100% of its stock until 1980. Max A. Ruefenacht, the plaintiff-respondent herein, alleges that early in 1980 he purchased a 50% interest in the company for $250,000 allegedly in reliance on financial documents and oral representations made by certain defendants.

Ruefenacht claims that the defendants violated §12(1) of the Securities Act of 1933, 15 U.S.C. §77(1)(1) (Amended Complaint, App. at 26a-27a), §12(2) of the Securities Act of 1933, 15 U.S.C. §77(1)(2) (Amended Complaint, App. at 27a-32a), §17(a) of the Securities Act of 1933, 15 U.S.C. §77(q)(a) and §10(b) of the Securities Act of 1934, 15 U.S.C. §78(j)(b) and Rule 10b-5 of the Securities and Exchange Commission promulgated thereunder, 17 C.F.R. §240.10b-5 (Amended Complaint, App. at 32a-36a). Additionally, Ruefenacht asserts state common law causes of action against the defendants (Amended Complaint, App. at 36a-44a).

An oral agreement was entered into between Ruefenacht and Birkle whereby Ruefenacht agreed to purchase 50% of what was designated

as the stock of the corporation. The sale was accomplished by Ruefenacht purchasing 2,500 newly issued shares of stock in Continental, representing 50% of the company's issued and outstanding shares of stock (R.2, App. at 225(a)).

Prior to Ruefenacht's purchase of the Continental stock, 49% of the outstanding stock was owned by Birkle, 50% was owned by a German corporation and 1% was owned by Birkle's wife (App. at 25a). After his purchase, Ruefenacht was 50% shareholder in the corporation, Birkle owned 24.5%, the German corporation owned 25% and Birkle's wife owned one-half of 1%. (App. at 24a-25a). Ruefenacht and Birkle agreed that Ruefenacht would purchase the 2,500 shares for $250,000 (App. at 52a). Ruefenacht only paid $120,000 of the agreed upon purchase price.

Ruefenacht was interested in acquiring Continental as a vehicle for importing beer produced by a European brewery owned by his wife's family. (R.2, App. at 52a). Ruefenacht testified that before he purchased the stock he was "checking out" the possibility of importing the beer. (1T: 22-7 to 23). After he told Mr. Ernest Stoecklin about his interest, Stoecklin introduced him to Birkle (1T: 19-13; 1T: 22-17 to 19).

Ruefenacht envisioned himself as a partner in Continental who, together with Birkle, would share the top level decisions of the company. (R.3, App. at 52a) Ruefenacht intended that he would become chairman of the board of directors and he was to receive an annual salary of $24,000.

Ruefenacht recognized that the reduced price he paid for his shares reflected the fact that he was to become actively involved in the management of Continental. (1T:

54-14 to 57-11; 1T: 63-19 to 64-13; Ruefenacht 12/21/81 deposition at T: 88-21 to 89-7, T: 125-3 to 126-9, App. at 280a-284a).

Not only did Ruefenacht intend by his purchase to become an active participant in the business, in fact his activities after the acquisition demonstrate such an active participation. As found by the Magistrate, Ruefenacht's "participation in the affairs of the company during the few months involved bespeaks an intention to actively participate in the company's affairs." (R.4, App. at 53a).

The parameters of Ruefenacht's intended control of Continental are illuminated by the provisions of a shareholders agreement which Ruefenacht and Birkle intended to enter into. (App. at 238a-249a). The agreement provided Ruefenacht with absolute veto power over all major decisions including business acquisition, sale of a major portion of the business, issuance of stock, declaration of dividends, and withdrawal of more than $500 above salary by either Birkle or Ruefenacht. (App. at 239a). While the agreement was never signed, the Magistrate specifically found that Ruefenacht intended to enter into a shareholders agreement substantially in this form (R.2, App. at 52a). Ruefenacht confirmed in his testimony that he and Birkle acted consistent with the terms of the agreement, as both had to agree on top level decisions of the company including issuance of stock, introduction of new product lines and borrowing funds. (R.3, App. at 53a; 1T: 64-12 to 13; 2T: 139-5 to 140-4; 2T: 78-4 to 25).

The status which Ruefenacht achieved by virtue of his acquisition of the stock gave him absolute veto power over all major deci-

sions. He was to become Chairman of the Board of Directors (R.3, App. at 53a) and he was to possess such control over Continental as his position as a director accorded to him (App. at 183a). Ruefenacht was also Continental's vice president and treasurer with the power to sign checks for the company (R.4, App. at 53a). Ruefenacht acknowledged the importance of the banking resolution (App. at 264a) which gave him the authority to direct the utilization of Continental's funds by issuing checks. (2T:121-24 to 122-1).

Ruefenacht was associated with Continental for a relatively short length of time (August through October of 1980). During that time, he participated in thirty meetings on behalf of Continental (R.5--6, App. at 54a-55a). He also spent time during his vacation in Europe on the business of Continental, participating in approximately six meetings with French wine producers (R.5, App. at 54a).

Considering the relatively short length of time Ruefenacht was associated with Continental, it is clear that he devoted a large amount of his own time to the daily affairs of Continental.

Ruefenacht took an active role in Continental's importing business. In the summer of 1980 he met with European wine and spirit producers in Alsace and Southern Germany, bringing with him a letter of introduction and credentials from Continental (R.5, App. at 54a; Ruefenacht 12/21/81 deposition at T:89-12 to 96-25, App. at 270a-278a). Ruefenacht was able to assist Continental's business because he was fluent in several languages including French and he had prior knowledge of the importing business.

After Ruefenacht returned to the United States from his European trip, he took part in numerous meetings where he met with various French wine producers (R.5, App. 54a). Ruefenacht took an active part in the meetings, including approving one particular import contract after he discussed with Birkle how much wine should be ordered. (2T: 107-25 to 108-4).

The trial court concluded that Ruefenacht "intended to exercise joint control of the business with Mr. Birkle; there would be equality of control." (App. at 61a). The record is clear and supports this conclusion.

SUMMARY OF ARGUMENT

In assessing the availability of Federal jurisdiction pursuant to the Securities Act of 1933, 15 U.S.C. §77b(1) and the Securities Exchange Act of 1934, 15 U.S.C. §78c(a)(10), the pivotal issue of statutory construction facing Federal courts is whether those Acts are intended to apply at all to the myriad of financial transactions which they potentially address. This Court has spoken to this issue on several occasions. In Securities & Exch. Com. v. Howey Co., 328 U.S. 293 (1946), this Court devised an "economic reality" test, whereby a financial transaction would be subject to the control of the Securities Acts only where, inter alia, the purchaser is led to expect that profit will be derived solely from the efforts of a third party. Subsequent decisions of this Court, including United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975), have established that the "economic reality" test is the "guiding principle" applicable to all purported securities transactions, regardless of the characterization of the instrument by which the transaction is effectuated.

Applying this test to the transaction which gives rise to the present Complaint, it is clear that Federal jurisdiction pursuant to the Securities Acts cannot properly be invoked. Although plaintiff herein purportedly purchased shares of "stock" in Continental Import & Export Co., his own testimony and other evidence adduced in the court below unmistakably demonstrated that it was never his intention that profit would be derived solely from the efforts of others. The "economic realities" of this transaction, therefore, should have prohibited the applicability of the Securities Acts.

Certain Courts of Appeal, however, have erroneously bifurcated the test established in Forman depending upon whether the instrument in question is labeled as "stock" or an "investment contract." Further, those courts have interpreted Forman as prohibiting an examination of economic reality where the instruments at issue possess the characteristics associated with ordinary, conventional shares of stock. Similarly, in rejecting the "sale-of-business doctrine," the Third Circuit Court of Appeals in the present matter also expressly refused to apply the economic reality test to a transfer of stock bearing what it regarded as the traditional incidents of stock ownership.

Other Courts of Appeal, on the contrary, have correctly viewed the economic reality test as embodying the essential attributes which run through all of this Court's decisions defining a security. In this view, no particular transaction is exempted from that test. The District Court in the present matter also evaluated the applicability of the Securities Laws on the basis of the Howey/Forman test, and concluded that Federal jurisdiction was lacking since plaintiff herein did not expect that the profits of the enterprise would be derived solely or substantially from the efforts of others. The Court of Appeals erroneously reversed this ruling.

ARGUMENT

APPLICABILITY OF THE FEDERAL SECURITIES LAWS TO THE TRANSACTION AT ISSUE HEREIN MUST BE DETERMINED UNDER THE ECONOMIC REALITY TEST.

The issue before the Court is whether the "economic reality" test articulated by this Court in United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975) and other cases applies to this transaction where the economic reality of the transaction, albeit denominated by the parties as a transfer of "stock," reveals that the purchaser did not expect to derive profit solely from the efforts of others. The District Court concluded that the "economic reality" test should be applied and applying that test to the facts herein held that securities law jurisdiction was lacking. The Third Circuit disagreed, rejecting the "economic reality" test in transactions involving purchases and sales of stock. It is O'Halloran's position that the District Court properly applied the economic reality test and correctly concluded that the federal securities laws do not apply to this transaction.

There has been a sharp debate among the Courts of Appeal with respect to the issue of when the "economic reality" test must be applied. There is a sharp split of authority over whether Forman and other Supreme Court precedent mandate that the "economic reality" test apply in all circumstances where the federal securities laws are sought to be invoked, or only to transactions involving "non-traditional" or "unusual" instruments or facially "traditional" instruments lacking "traditional" characteristics.

The "economic reality" test on which the District Court below relied originated

Securities & Exch. Com. v. Howey Co., 328 U.S. 293 (1946). The Court therein considered whether the sale of units of land in a Florida citrus grove by deed, combined with a management contract for cultivating and marketing the produce and remitting the net proceeds to the owner, constituted an "investment contract" under the Securities Act of 1933, 15 U.S.C. §77B(1). Preliminarily, the Court looked to the statutory definition of "security" which, inter alia, included an "investment contract." The Court then considered whether, "... under the circumstances," [id. at 297, emphasis added] the transaction at issue constituted such an investment contract, thereby invoking federal jurisdiction pursuant to, as well as the protection of, the Securities Acts.

At the outset, the Court noted that neither the statute itself nor its legislative history defined the relevant term. Thus, the Court looked to previous construction of "investment contracts" by state courts prior to the adoption of the federal statute. The principal virtue of this construction, according to the Supreme Court, was that "[f]orm was disregarded for substance and emphasis was placed upon economic reality." Id. at 298 (emphasis added). Accordingly, the Court adopted the same interpretation to govern the application of the Securities Acts:

> In other words, an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal cer-

> tificates or by nominal interests in the physical assets employed in the enterprise.

Id. at 299 (emphasis added). Stressing the reason for its adherence to a standard of "economic reality," the Court concluded:

> [i]t embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.

Id.

The Court's next major focus on the reach of federal securities law occurred in United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975) in which, as will be seen, the Court continued to emphasize the fundamental necessity of examining the economic reality of the transaction. At issue in Forman was the applicability of the Securities Act of 1933 and the Securities Exchange Act of 1934 to the sale of shares of stock in a state subsidized nonprofit housing cooperative. This transaction posed a similar definitional (and, hence, jurisdictional) inquiry.

Of the two grounds on which the Court of Appeals relied in concluding that the Securities Acts were applicable, the first was the express language of the Acts themselves: it held that "... since the shares purchased were called 'stock' the Securities Acts, which explicitly include 'stock' in their definitional sections were literally applicable." Id. at 846. This rationale was expressly rejected by the Supreme Court. Instead, it "... adhere[d] to the basic principle that has guided all of the

[Supreme] Court's decisions in this area, "[id. at 848, emphasis added], viz, the economic reality test of Howey, supra. Id.; see also Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). The Court explained:

> Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto.

Id. at 849.*

---

*As further support for its view that a contextual rather than a literal application of the Securities Acts was required, the Court in Forman referred to its earlier analysis of the term "security" in SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1946). While recalling statements in that opinion to the effect that "[i]nstruments may be included within [the definition of a security], as a matter of law, if on their face they answer to the name or description," and that a security "might be shown by proving the document itself, which on its face would be a note, a bond, or a share of stock," [Joiner, supra, 320 U.S. at 351, 355, cited by Forman at 421 U.S. 849-50, emphasis supplied by Forman], the Court also stressed that "[b]y using the conditional words 'may' and 'might'... the Court [in Joiner] made clear that it was not establishing an inflexible rule barring inquiry into the economic realities underlying a transaction." Forman, supra, 421 U.S. at 850. Thus, the Court's repeated references to Howey, supra, Tcherepnin, supra and Joiner, supra, explain its description of the "economic reality"

(Footnote continued on next page)...

The Court applied in this portion of its opinion the "economic reality" test for identifying "securities" transactions, consisting of the three part formula previously established by the Court in Howey with reference to an "investment contract." To qualify as a "securities" transaction, the transaction must involve (1) an investment of money, (2) in a common enterprise, with (3) an expectation of profits to come from the entrepreneurial or managerial efforts of others. 412 U.S. at 852.

The Court applied this three part test, concluding that the sale of the cooperative housing stock at issue was not the type of transaction Congress intended to regulate under the Securities Acts because "the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit" 421 U.S. at 851.

The Court of Appeals in Forman had held in alternative holding that the Securities Acts were applicable because the cooperative housing shares were "investment contracts." In the latter portion of its opinion, this Court in Forman rejected the Court of Appeals' alternative holding.

The Court began its analysis in the latter portion of its opinion by again applying the "economic reality" analysis, stating:

> In considering these claims [that the shares were "investment contracts"] we

---

...(Footnote continued from previous page)

test as "... the basic principle that has guided all of the [Supreme] Court's decisions in this area." Forman, supra at 848.

again must examine the substance -- the economic realities of the transaction -- rather than the names that may have been employed by the parties. We perceive no distinction, for present purposes, between an 'investment contract' and an 'instrument commonly known as a security.' In either case, the basic test for distinguishing the transaction from other commercial dealings is

> whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.

Forman, supra, 421 U.S. at 852 (emphasis added), citing Howey, supra, 328 U.S. at 301.

The Forman Court clearly acknowledged a unified standard for the evaluation of all "securities." In other words, the "economic reality" test, the "guiding principle" in this general inquiry, is applicable to all purported security transactions, regardless of the characterization of the instrument by which the transaction is effectuated. The fundamental element of that test is the expectation that profits will be derived from the efforts of others. As the Court summarized in Forman, "[w]hat distinguishes a security transaction -- and what is absent here -- is an investment where one parts with his money in the hope of receiving profits from the efforts of others..." Forman, supra, 421 U.S. at 858.

* * *

The Forman Court's discussion of the "investment contract" issue in the latter part of its Opinion has lead certain lower federal courts to interpret Forman as establishing a wholly bifurcated, "seriatim" test,

the two parts of which must be applied discretely depending on whether the instrument is labeled as "stock" or "investment contract." This approach is illustrated by decisions from the Second Circuit Court of Appeals in Golden v. Garafalo, 678 F.2d 1139 (2nd Cir. 1982) and Seagrave Corp. v. Vista Resources, Inc., 696 F.2d 227 (2d Cir. 1982). This approach proceeds on two basic assumptions: first, that Forman intended to promulgate a "two-part, seriatim" test, only the second part of which consists of the "economic reality" analysis and, second, that Forman in fact prohibited an examination of economic reality where the instruments at issue possess the "characteristics associated with ordinary, conventional shares of stock." The essential attribute of this method of analysis is the resort to the literalism of the statutory definition which was expressly repudiated by the Supreme Court. Golden, for example, frankly rejects the concept that economic reality is "... the universal jurisdictional test under the Acts." Golden v. Garafalo, supra, 678 F.2d at 1144. Similarly, the Court in Seagrave Corp. v. Vista Resources, Inc., supra, concluded, on the authority of Golden, that "[w]e must now regard ordinary 'stock' as 'securities' within the meaning of the '33 and '34 Acts regardless of the nature of the transaction in which the 'stock' is transferred." 696 F.2d at 229 (emphasis added). Accord, Daily v. Morgan, 701 F.2d 496 (5th Cir. 1983); Coffin v. Polishing Machines, Inc., 596 F.2d 1202 (4th Cir. 1979), cert. den'd, 444 U.S. 868 (1979). See also, Note, Repudiating the Sale of Business Doctrine, 83 Colum.L.Rev. 1718 (1983).

The refusal of the above-cited Courts to examine the nature of the underlying transaction is at odds with the economic reality test which the Supreme Court has consistently

employed in evaluating all purported security transactions and is inconsistent with post Forman Supreme Court authority.

In International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979), the Court considered whether a non-contributory, compulsory pension plan was an "investment contract." Rejecting the plaintiff's argument that the Federal Security laws applied, the Court stated:

> In Forman, supra, we observed that the Howey test, which has been used to determine the presence of an investment contract, 'embodies the essential attributes that run through all the Court's decision to finding a security' 421 U.S. at 852, 44 L.Ed. 2d 621, 95 S.Ct. 2051.

439 U.S. at 558 n.11.

In Marine Bank v. Weaver, 455 U.S. 551 (1983), the Court applied the "economic reality" analysis to the following fact situation. Plaintiffs had guaranteed a bank loan made to third parties and as collateral pledged a Certificate of Deposit. Plaintiffs received in return from the third party borrowers the right to receive 50% of the net profit of a business owned by the borrowers, the right to use facilities of the borrowers' business, and the right to veto future loans to the borrowers. The District Court dismissed the Complaint for lack of federal jurisdiction and the Third Circuit Court of Appeals reversed.

This Court considered two issues: first, whether the Certificate of Deposit was a "security," and second, whether the private agreement between the parties was a "security."

The Court initially held that the Certificate of Deposit was not a security, stating:

> The definition of "security" in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires. It is unnecessary to subject issuers of bank certificates of deposit to liability under the anti-fraud provisions of the Federal Securities laws since the holders of bank certificates of deposit are abundantly protected under the Federal Banking laws. We therefore hold that the Certificate of Deposit purchased by the Weavers is not a security.

455 U.S. at 558-59.

The Court went on to hold that the agreement between the parties was not a security for two reasons: first, the transaction had a "unique character" because it was specifically negotiated between the parties to accommodate their needs, and second, that the plaintiffs' right to veto future borrowings gave them "a measure of control" over the operation of the business not characteristic of a security. 455 U.S. at 560.

The Weaver Court left no doubt that the "economic reality" test is to be applied uniformly, stating:

> Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

455 U.S. at 560 n.11.

Numerous lower federal courts have followed the Forman method of analysis. In

Fredericksen v. Poloway, 637 F.2d 1147 (7th Cir. 1981), cert. denied 451 U.S. 1017 (1981), for example, the Court considered the applicability of the Securities Acts to a transaction which was characterized by an agreement to purchase the assets of a business, a stock purchase and voting trust agreement and employment and management agreements between the purchaser and seller. The Court noted at the outset:

> This case involves the scope of the federal securities laws. The question we confront is whether alleged fraud regarding the sale of assets and stock in a corporation falls within the scope of those laws. Not all sales transactions which involve 'stock' are necessarily covered by the securities laws. Rather, the test for coverage in general is whether the purchaser is placing money in the hands of another who will control the funds and business decisions. If, however, the purchaser is assuming control of the critical decisions of the corporation, then the transaction is not considered to involve 'securities.'

Id. at 1148. Referring to the Forman Court's observation that securities transactions are economic in character [Forman, supra, 421 U.S. at 849], the Fredericksen court concluded that "the 'economic reality' of a transaction is always a key issue." Fredericksen, supra, 637 F.2d at 1152, n.2 (emphasis added).

This position has been consistently followed by the Seventh and other Circuits. In Canfield v. Rapp & Son, Inc., 654 F.2d 459 (7th Cir. 1981), the Court recalled the observation in Forman that the economic reality test "embodies the essential attributes that

run through all of [the Supreme] Court's decisions defining a security" [id. at 464, citing Forman, supra, 421 U.S. at 852], and concluded that the Supreme Court "... did not exempt any particular type of security from the test." Canfield, supra, 654 F.2d at 464. At the same time, while agreeing that the name and characteristics of a particular instrument are "... factors to consider in applying the economic reality test," [id. at 464-65], the Court nonetheless concluded that

> In order to determine whether these factors are dispositive, it still is necessary to look beyond the form of the instrument involved to the reality of the particular transaction.

Id.

The application of the economic reality test was further explored in Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982). The Court therein addressed the distinction posited by the Second Circuit in Golden v. Garafalo, supra, between "unique or idiosyncratic instruments" and conventional or "garden-variety common stock." Golden, supra, 678 F.2d at 1144; Sutter, supra, 687 F.2d at 200. The Golden Court had concluded that the economic reality test could only be applied to the unique instrument.

In rejecting this position, the court in Sutter looked first to the Supreme Court's post-Forman decision in Weaver. As in Weaver, the Court in Sutter v. Groen was faced with an instrument -- common stock -- which was also specifically included in the statutory definition of "security." Nonetheless, the Sutter Court looked to Weaver for guidance and observed that "[t]he [Supreme] Court got around the seemingly uncompromising statutory language by treating

the word 'context' in the introductory clause of section 3(a)(10) as having reference to the economic as well as linquistic context." Sutter, supra, 687 F.2d at 200. As to that context, the Court also remarked that "[t]here is a clear difference in principle between an investor and an entrepreneur..." [id. at 201], and concluded that, in the case before it, the purchaser had "[t]he entrepreneurial intention -- to buy assets to manage, rather than to rent capital to those who want to manage..." Id. at 202. This, of course, is precisely the third prong of the economic reality test, viz, that the investor must be "... led to expect profits solely from the efforts of the promoter or a third party." Howey, supra, 328 U.S. at 299.

This approach, it is submitted, is manifestly more faithful to the consistent pronouncements of the Supreme Court on this issue. It is also the approach that has been followed by numerous federal courts. See, King v. Winkler, 673 F.2d 342 (11th Cir. 1982); Kaye v. Pawnee Construction Co., 680 F.2d 1360 (11th Cir. 1982); Christy v. Cambron, 710 F.2d 669 (10th Cir. 1983); Chandler v. Kew, Inc., 691 F.2d 443 (10th Cir. 1977); Goodman v. De Azoulay, 554 F. Supp. 1029 (E.D. Pa. 1983); Oakhill Cemetery, Inc. v. Tri-State Bank, 513 F. Supp. 885 (N.D. Ill. 1982); Anchor-Darling Industries, Inc. v. Suozzo, 510 F. Supp. 659 (E.D. Pa. 1981); Reprosystem, B.V. v. SCM Corporation, 522 F. Supp. 1257 (S.D.N.Y. 1981).

Applying the "economic reality" test to the facts of this case, it is clear that the transaction did not satisfy the test of Howey and Forman, because "the profits of the enterprise would not be derived "soley" or substantially from the efforts of others." (App. at 307a-12 to 14). This conclusion is

not seriously disputed by Respondent Ruefenacht.

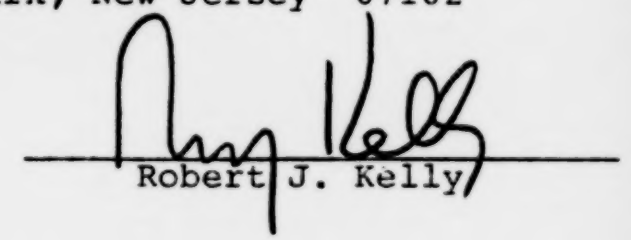
The trial court was clearly correct in ruling that the transaction at issue herein fails the Howey/Forman test because as a result of Ruefenacht's control of and participation in the company, "the profits of the enterprise would not be derived 'solely' or substantially from the efforts of others." (App. at 307a-13 to 14) As set forth in the Statement of Facts, Ruefenacht had control by virtue of his status with the company and by virtue of his actual participation. Ruefenacht's powers and activities are equivalent to control over Continental's affairs so that plaintiff "was not a passive investor who relied on others to manage the business." (App. at 307a-20 to 21).

CONCLUSION

The judgment of the Court of Appeals, insofar as it reversed the dismissal of the Complaint against petitioner and respondent Christopher J. O'Halloran should be reversed.

Respectfully submitted,

TOMPKINS, McGUIRE & WACHENFELD
Attorneys for Defendant-Appellee,
Christopher J. O'Halloran
550 Broad Street
Newark, New Jersey 07102

By: 
Robert J. Kelly

(6)

No. 84-165

In The

Supreme Court of the United States

October Term, 1984

W. GEORGE GOULD,

Petitioner,

vs.

MAX A. RUEFENACHT, et al.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF RESPONDENT

PETER S. PEARLMAN
COHN & LIFLAND, ESQS.
Park 80 Plaza West One
Saddle Brook, New Jersey 07662
(201) 845-9600

Attorney for Respondent
Max A. Ruefenacht

On the Brief

JEFFREY W. HERRMANN
PETER S. PEARLMAN
ANN M. DOUGHERTY

COCKLE LAW BRIEF PRINTING CO., (800) 835-7427 Ext. 333

46PP

COUNTER STATEMENT OF QUESTION PRESENTED

Is the purchase of fifty percent of the shares of stock of a closely held corporation by one who participates in the affairs of the corporation the purchase of "securities" within the meaning of the federal securities laws?

TABLE OF CONTENTS

TABLE OF CONTENTS—Continued

TABLE OF AUTHORITIES

CASES:

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

No. 84-165

In The

Supreme Court of the United States

October Term, 1984

W. GEORGE GOULD,

Petitioner,

vs.

MAX A. RUEFENACHT, et al.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF RESPONDENT

STATEMENT OF THE CASE

In the spring of 1980, respondent, Max A. Ruefenacht (Ruefenacht), was approached by Joachim Birkle (Birkle) to invest in a corporation known as Continental Import & Export, Inc. (Continental), a New Jersey corporation engaged principally in the importation of wine,

spirits and mineral water into the United States and the wholesale sale thereof. The investment was to take the form of a purchase by Ruefenacht of one-half of Continental's stock (J.A.52a).

At the time that Birkle first approached Ruefenacht all of the outstanding stock of Continental was held by Birkle, his wife Elizabeth Birkle, and Lenzenhof GmbH (Lenzenhof), a corporation owned by the Birkle family (J.A.25a). Birkle maintained absolute management authority over Continental, subject only to a Board of Directors consisting of Birkle, petitioner George Gould (Gould) and, at various other times, other individuals who served at Birkle's pleasure. At all times, Birkle dominated the operations of the Board of Directors and the activities of Continental (R.185a).[1]

As an incentive to entice Ruefenacht to purchase one-half of the shares of stock of Continental, Birkle and Gould, acting on behalf of Continental, gave Ruefenacht financial statements, prospectuses, *pro forma* balance sheets and various other documents. This documentation was geared to make the financial position of Continental appear extremely bright and to portray the company as richly endowed with assets. By way of example, the documents purported to demonstrate that Continental had import contract rights worth $400,000, goodwill and licenses

[1]As used herein R. shall refer the record of the district court as certified to the court of appeals. The pagination shall be the same as utilized in the appendix filed with the court of appeals.

worth $250,000, total assets of over $838,000 and total equity of over $792,000 (J.A.28a).

Gould is, and at all times in question has been, an attorney licensed to practice law in the State of New Jersey and functioned both as corporate counsel to Continental and as a director of that corporation (J.A.26a). In these capacities he prepared and passed upon, a directors' resolution establishing the values assigned to the import contract rights and the goodwill and licensed indicated above (J.A.29a). Gould submitted that resolution to Christopher J. O'Halloran (O'Halloran),[2] a certified public accountant who prepared the financial statements on behalf of Continental (J.A.25a-26a).

Ruefenacht alleges that the representations made in those documents as well as other statements constituted material misrepresentations of fact. Further, it is alleged that the various defendants omitted to state material facts necessary to make the facts contained in the documents and oral statements not misleading (J.A.28a-36a).

In reliance upon the misrepresentations, and in ignorance of the omitted facts, Ruefenacht agreed to invest $250,000 in Continental to be used for working capital by buying 2500 shares of its common stock at $100 per share (J.A.46a). After Ruefenacht had paid an initial $120,000 in connection with the stock purchase, he learned of the false nature of the representations made (R.182a). Ac-

[2]O'Halloran is a defendant in this action, and a respondent on this appeal.

cordingly, he sought to rescind the transaction and obtain return of his money, which the defendants refused to do. Based upon the foregoing circumstances, Reufenacht instituted this action (J.A.27a).

At no time did Ruefenacht intend to, nor did he, participate to any significant extent in the daily management of the business affairs of Continental. (R.183a). On the contrary, at all times Ruefenacht was a full time employee of Autobern Trading Corporation (Autobern), an exporter of American automobiles[3] (J.A. 53a). Ruefenacht's association with Continental was in the capacity of an investor and not as a manager or an employee. In fact, Ruefenacht never received any compensation in the form of salary or otherwise for any actions which he may have undertaken on behalf of Continental (R.186a).

At no time did Ruefenacht intend to take over the actual management of Continental or otherwise absolutely direct or control its operations. While it was his desire to help Continental in any way possible so as to enhance the value of his investment, it was always the intention of the parties that Birkle would run the business (R.184a).

Although it has been contended that Ruefenacht did undertake to perform certain functions for Continental (Pb3-4) (which he never has denied), nowhere in any of the facts presented is there any evidence that he intended to control, manage or run the business, or even work in it on a day-to-day basis. The most that can be said is as follows:

---

[3]Autobern was brought in as a third party defendant in this action by Gould.

1. Ruefenacht intended to become a director of Continental, although he never did in fact become one and never attended any directors' meetings (J.A.53a).

2. Ruefenacht met with some salesmen of Continental and discussed the hiring of one salesman with Birkle (J.A.54a).

3. Ruefenacht signed a banking resolution denominating himself as an officer of the corporation, which resolution was prepared for the purposes of permitting him to sign checks because Birkle was contemplating a trip out of the country and would be unavailable to do so (J.A.53a).

4. Ruefenacht signed an application for a liquor license (a solicitor's permit) (J.A.47a).

5. While on his summer vacation in Europe in 1980 Ruefenacht visited several potential vendors for Continental (J.A.54a).

6. On one occasion Ruefenacht asked Gould to expedite a liquor license for which Gould was applying in his capacity as attorney for Continental (J.A.55a).

7. On at least one occasion Ruefenacht visited certain warehouses with Birkle (J.A.55a).

The suit instituted by Ruefenacht seeks damages and, in the alternative, recission for violations of Sections 12(1), 12(2) and 17(a) of the Securities Act of 1933 (the 1933 Act), 15 U.S.C. §77(1)(1)-(2), 77(q)(a) (1982); Section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act), 15 U.S.C. §78(j)(b); and Rule 10b-5 of the Securities and Exchange Commission promulgated thereunder, 17 C.F.R. §240.10b-5 (1984). Ruefenacht also al-

leged pendent state law claims for fraud, negligence and breach of fiduciary duties.

Gould filed a motion for summary judgment seeking to dismiss all federal securities law claims on the grounds that the shares of stock purchased by Ruefenacht were not "securities" within the definition of the federal securities laws. The motion further sought to dismiss the balance of the complaint based upon lack of federal jurisdiction. After the motion was denied without prejudice, (J.A.45a) limited discovery was undertaken respecting the extent of control which Ruefenacht intended to assert over the affairs of Continental[4]. At the conclusion of discovery, an evidentiary hearing was held at which time the Magistrate determined:

> Based upon the foregoing findings of fact it is concluded that Ruefenacht intended to purchase a 50%

---

[4]At the time that it denied Gould's initial application for summary judgment without prejudice, the trial court established the following guidelines:

> He [Mr. Ruefenacht] did not have total control, owning only 50% of the stock, and he was not in control of the day-to-day activities, although he did participate in some of them. Although Ruefenacht contributed his talents and efforts to Continental's pursuit of business and profits, it has not been shown that his goal was to control the entire business. If he was not in overall control, the Court must conclude that the efforts of those who *were* running the business, such as Birkle, were to be the primary source of profits realized on Ruefenacht's investment. As such the investment would meet the test for a security, and the transaction would be governed by the federal laws. A hearing is necessary to resolve these questions. The Court will retain jurisdiction over both the federal and pended [sic] State claims, and defendants' motion is DENIED without prejudice to their right to renew upon the submission of all proofs. (Emphasis supplied by Court). (J.A.50a).

> ownership of the shares of stock of Continental and to exercise all that control to which a 50% owner is entitled. It has not been shown that there was any possible way that Ruefenacht could have exerted more control. His actions were at all times subject to the absolute veto power of his partner, Mr. Birkle. The actions of the parties are consistent with the equality of control and joint participation in the business of the corporation is clearly demonstrated by the evidence presented. There is no evidence to the contrary. (J.A.56a).

Upon a review of the Magistrate's findings, the district court granted summary judgment in favor of all defendants. Accepting the validity of the so-called "sale of business doctrine", the district court ruled:

> The trend of the law is to apply the 'economic reality' test to purchases of less than all of the company's stock to determine whether the purchaser would actively manage his investment. Because Mr. Ruefenacht intended to jointly manage Continental with Mr. Birkle, he did not purchase 'securities' as defined in the federal acts. (J.A.62a).

In its discretion, the court dismissed all pendent state law claims pursuant to *United Mine Workers v. Gibbs*, 383 U.S. 715 (1966).

On Ruefenacht's appeal, the Court of Appeals for the Third Circuit reversed, holding that no economic analysis of the transaction in which Ruefenacht participated was appropriate and that "[t]he sale of all or part of a business effectuated by the transfer of stock bearing the traditional incidents of stock ownership is the sale of a 'security' under the 1933 and 1934 Acts." *Ruefenacht v. O'Halloran*, 737 F.2d 320, 339 (3d Cir. 1984).

SUMMARY OF ARGUMENT

I

The applicability of the federal securities laws to the case at bar is mandated by the clear and unambiguous language of the definitional sections of the relevant statutes. The instruments purchased by the respondent contain all of the attributes normally associated with shares of stock. As the term security by definition includes stock, the decision of the Court of Appeals for the Third Circuit should be affirmed.

The doctrine espoused by petitioner, that one who purchases a "controlling" interest in a business in which he invests is afforded no remedy under the securities acts, is not supported by either the statutes' language or their legislative history. Rather, the statutes, while explicitly exempting from coverage certain instruments, were designed to afford protection to all purchasers of stock, whether of public or private corporations and regardless of whether the purchaser was a passive investor or businessman active in the corporation's affairs.

II

In an unbroken line of decisions, this Court has upheld the principle that purchasers of traditional shares of stock are afforded the protection of the federal securities laws. While the Court has created various tests to determine whether this protection should be extended to various novel and exotic types of instruments, such tests never have been utilized to determine the applicability of the statutes to instruments that clearly fall under any of the specifically enumerated types of instruments that are definitionally securities.

III

Adoption of petitioner's position would create great uncertainty as to whether a transaction was governed by the federal securities laws. Further, purchasers of stock need the protection offered by the securities acts and have come to rely upon the existence of this protection to supplement any common law remedies that might exist. Most importantly, adoption of the doctrine urged by the petitioner would lead to wholly inequitable and arbitrary results.

POINT I

Traditional Stock Is A Security Within The Meaning Of The Federal Securities Laws Regardless Of The Economic Context Of The Transaction.

A. The Plain Meaning Of The Statutory Language Requires That The Federal Securities Laws Be Applied To The Transaction In Question.

The thrust of petitioner's argument is that the Court should not apply the federal securities laws "to transactions within the statutes' letter but not their spirit" (Pb7). Confronted with a statue which in unambiguous language clearly requires application to the case at bar, petitioner would have this Court disregard long-established rules of statutory interpretation that require adherence to the plain meaning of a statute's text. *Richards v. United States,* 369 U.S. 1, 9 (1961). Rather, petitioner urges the Court to embrace a doctrine derived not from the language of the statute, but from a twisted view of legislative history.

Faced with a similar argument, the Court in *Ex Parte Collett,* 337 U.S. 55, 61 (1949), set aside such distorted views of statutory interpretation, stating:

> The short answer is that there is no need to refer to the legislative history where the statutory language is clear. 'The plain words and meaning of a statute cannot be overcome by a legislative history which, through strained processes of deduction from events of wholly ambiguous significance, may furnish dubious bases for inference in every direction.' *Gemsco v. Walling*, 1945, 324 U.S. 244, 260, 65 S.Ct. 605, 614, 89 L.Ed. 921. This canon of construction has received consistent adherence in our decisions.

Any exercise in statutory interpretation must begin with an examination of the statutory language itself. *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 558 (1979). Utilizing definitional sections that are virtually identical, Congress defined "security" in both the 1933 and 1934 Acts as any of fourteen separately listed types of instruments as well as any instrument "commonly known as a 'security' ". 15 U.S.C. § 78c(a)(10). Included in this descriptive list of what constitutes a "security" is the term "stock" which has been categorized rightly as the "paradigm of a security", *Daily v. Morgan*, 701 F.2d 496, 500 (5th Cir. 1983), and "so quinessentially a security as to foreclose further analysis", L. Loss, *Fundamentals Of Securities Regulation*, 212 (1983).

In its first examination of the statute in question, this Court had little problem with the term "stock":

> In the Securities Act the term 'security' was defined to include by name or description many documents in which there is common trading for speculation or investment. *Some, such as notes, bonds, and stocks, are pretty much standardized and the name alone carries well settled meaning.* Others are of more variable character and were necessarily designated by more descriptive terms, such as 'transferable share', 'investment contract', and 'in general any interest or instrument commonly known as a security.' We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. *Instruments may be included within any of these definitions, as matter of law, if on their face they answer to the name or description.* (Emphasis added).

S.E.C. v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

In the case *sub judice* there is no question that respondant Ruefenacht purchased shares of stock, nor is there any question that the district court was correct in determining that the shares in question have all of the "traditional" attributes of stock.[5] Accordingly, giving effect to the ordinary meaning of the language of the statutes, Ruefenacht's stock must be deemed to be a "security" and the transactions in question subject to the provisions of the 1933 and 1934 Acts. As was noted by the Court in *Joiner*, 320 U.S. at 355:

---

[5]The district court observed:

> In the present case the stock which Ruefenacht received contains all the attributes mentioned by the Forman Court [United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 851 (1975)] as indicating that the transaction did involve a security. (J.A.50a).

See also, *Ruefenacht v. O'Halloran*, 737 F.2d at 338. It should be noted that the stock in question was free of any restrictions at the time of its initial issue, but was later made subject to certain restrictions on transferability pursuant to a shareholders agreement (R. 238a-269a). Such restrictions are common among shareholders in a closely held corporation and in New Jersey where Continental was incorporated, statutorily permissible to the extent that they do not unreasonably restrict transfer. N.J. Stat. Ann. § 14A:7-12 (West 1984). Accordingly, Ruefenacht's shares were transferable subject to certain restrictions. Further, transactions involving the stock of closely held corporations are clearly within the purview of the securities acts. *Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975).

> In the present case we do nothing to the words of the Act; we merely accept them. It would be necessary in any case for any kind of relief to prove that documents being sold were securities under the Act. In some cases it might be done by proving the document itself, which on its face would be a note, a bond, or a share of stock.

This construction follows long accepted principles of statutory interpretation. The term "stock" is one of a series of terms which are alternate examples of the defined term, security:

> In construing the statute we are obligated to give effect, if possible, to every word Congress used. United States v. Menasche, 348 U.S. 528, 538-539 (1955). Canons of construction ordinarily suggest that terms connected by a disjunctive be given separate meanings unless the context dictates otherwise; . . . .

Reiter v. Sonotone Corp., 442 U.S. 330, 339 (1978).

Once a court determines that the instrument in question is traditional stock or one of the other types of instruments specifically enumerated in the definition of "security", the inquiry into the applicability of the federal securities laws is at an end. Only when dealing with an exotic or difficult to categorize instrument is it necessary to consider the applicability of more general terms, such as "investment contract". *Joiner*, 320 U.S. at 351; *Tcherepnin v. Knight*, 389 U.S. 332, 342 (1967).

Decisions upholding the sale of business doctrine, which hold that the general term "investment contract" circumscribes the scope of specific terms such as "stock", *e.g., King v. Winkler*, 673 F.2d 342 (11th Cir. 1982), result in rendering virtually all of the definitional language of the statute superfluous. If Congress had intended to define "security" simply within the parameters of "investment contract" it easily could have done so. The use of a listing of fourteen alternate descriptive terms to define security requires that each of those terms be given separate meaning. *McDonald v. Thompson*, 305 U.S. 263, 266 (1938). Any other reading would render the listing of specific categories of security a mere redundancy in violation of settled principles of statutory interpretation *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307-308 (1961).

B. Neither The "Context" Clause Nor Legislative History Supports An Interpretation Which Would Disregard The Plain Meaning Of The Securities Statutes.

Only under rare and exceptional circumstances will a court override the literal terms of the statute. *Crooks v. Harrelson*, 282 U.S. 55, 60 (1930). Departures from the letter of the law are permitted only in those situations in which a literal reading would result in an "absurdity . . . so gross as to shock the general moral or common sense." *Id.* In this case, however, petitioner does not contend that a literal application of the statute to the case at bar would lead to an absurd result. Rather, he bases his position upon an unsupportable construction of the "context" clause and an examination of legislative history through rose-colored glasses.

1. *The phrase "unless the context otherwise requires" prefacing the definition of "security" refers to the statutory context, not the economic context of the transaction in which the instrument is used:* The definition of a security in both the 1933 and 1934 Acts begins with the prefaced language "[w]hen used in this subchapter, unless tthe context otherwise requires—". Where logic would

dictate that the phrase "the context" refers to the context of the statute itself, petitioner uses the phrase as a spring board to argue that before applying the federal securities laws a court must consider the factual and economic context of the transaction in question. The legislative history of the term "security" clearly points to the opposite conclusion.

The "context" clause precedes all definitions contained in the statutes in question as well as numerous other federal statutes. In the past this Court has interpreted the phrase to require the judiciary to consider the meaning of words in the context of the *particular statute* under consideration. *S.E.C. v. National Securities,* 993 U.S. 453, 466 (1969):

> Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and 1934 Acts preface their lists of general definitions with the phrase 'unless the context otherwise requires'.

Any other result leaves unexplained the question of why the context clause was used to modify all the definitions of both the 1933 and 1934 Acts and not limited to those instruments that are subject to economic transactions. The context clause modifies, *inter alia,* the term "territory" in the 1933 Act, 15 U.S.C. § 77b(6), and the term "records" in the 1934 Act, 15 U.S.C. § 78c(37). It is difficult to conceive of any factual or economic situation which would have to be examined in order to determine whether Puerto Rico was a territory or whether books of account constituted a record.

Nor does the legislative history support the illogical argument of petitioner. As examined in detail by the court

of appeals below, *Ruefenacht,* 737 F.2d at 330-32, the Senate version of the 1933 Act contained the phrase "unless the *text* otherwise indicates," H.R. 5480, 73d Cong. 1st Sess. 39 (1933) (as enacted by the Senate May 10, 1933); S.875, 73d Cong., 1st Sess. 1 (1933), while an early House version of the bill containing identical language was modified to state "unless the *context* otherwise requires". *See* H.R. 5480, 73d Cong., 1st Sess. § 1 (1933) (as enacted by the House on May 5, 1933). A conference committee ultimately chose the House version without any indication of the reasons for that decision. *H. Conf. Rep. No. 152,* 73d Cong., 1st Sess. 24-25 (1933). The lack of any legislative history forces the conclusion that Congress expected judicial scrutiny to be limited to a consideration of the context of the particular statute in which a defined term might be used and not leave open the door for a wide ranging exploration of the underlying factual and economic context of the transaction in question. *Exchange National Bank v. Touche Ross & Co.,* 544 F.2d 1126, 1138 (2d Cir. 1976).

2. *The sale of business doctrine finds no support in legislative history:* Finding no support in the language of the statutes themselves petitioner seeks to avoid their plain meaning by contending that legislative history demonstrates that Congress could not have meant what it said because (at least in petitioner's opinion) it was interested in protecting passive investors as opposed to those who took a more active role in the affairs of the corporation in which they invested.

Any inquiry into legislative history of the definitional section must begin with the report of the House Committee On Interstate And Foreign Commerce. In sum-

marizing the provisions of the proposed 1933 Act, the report states:

> Paragraph (1) defines the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933).

The failure to specifically define the term "stock" in the statute leads to the conclusion that Congress intended that that word be construed in accordance with its ordinary everyday meaning. *Russello v. United States,* 104 S.Ct. 296, 299 (1983). The concept that some stock sales, *e.g.*, when control of a corporation is being transferred, would not be subject to coverage under the securities laws is nowhere to be found within the House report. In fact, the committee clearly stated the desire to regulate sales in which a controlling group of shareholders seeks to sell its interest in a corporation:

> All the outstanding stock of a particular corporation may be owned by one individual or a select group of individuals. At some future date they wish to dispose of their holdings and to make an offer of their stock to the public. Such a public offering may possess all the dangers attendant upon a new offering of securities.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 13-14 (1933).

Furthermore, the 1933 Act contains specific sections under which certain types of securities are exempted, 15 U.S.C. § 77c, and certain securities transactions are not subject to the registration provisions of the statute, 15 U.S.C. § 77d. However, within this scheme even the sale of securities that are exempt from the statute's registration requirements are still subject to the anti-fraud provisions, 15 U.S.C. § 77q(c). Neither petitioner nor any of the courts that have espoused the sale of business doctrine have made any attempt to explain why Congress would go to such pains to explicitly exempt certain types of securities transactions from the registration requirements while at the same time silently or by some vague inference removing transactions such as that between the parties in the case at bar entirely from the coverage of the securities laws. Furthermore, no explanation is offered why Congress in enacting the Williams Act, 15 U.S.C. § 78n, would utilize the definition of security found in 15 U.S.C. § 78c(10), although that legislation was specifically designed to regulate tender offers seeking control of corporations.

Undoubtedly, the statutes in question were designed in order to provide protection to investors. But there is no evidence in the legislative history that that protection was limited to those purchasers of stock who did not take an active role in the business in question:

> While investor protection was a constant preoccupation of the legislators, the record is also replete with references to the desire to protect ethical businessmen. See 77 Cong. Rec. 2925 (1933) (remarks of Rep. Kelly); Id., at 2983 (remarks of Sen. Fletcher); Id., at 3232 (remarks of Sen. Norbeck); S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933). As Representative Chapman stated, '[t]his legislation is designed to protect not only the investing public but at the same time to protect honest corporate business.' 77 Cong. Rec. 2935 (1933). Respondent's assertion that Congress' concern was limited to investors is thus manifestly inconsistent with the legislative history.

United States v. Naftalin, 441 U.S. 768, 776 (1979).

Thus the sale of business doctrine finds no support either in the statutory text or in the legislative history. Petitioner's argument is no more than a plea for this Court to rewrite the federal securities laws so that he may avoid judicial scrutiny of his misdeeds. Dismissing similar arguments in the past, this Court has noted:

> Had Congress intended so fundamental a distinction, it would have expressed that intent clearly in the statutory language or the legislative history. It did not do so, however, and it is not this Court's function to 'sit as a super Legislature,' Griswold v. Connecticut, 381 U.S. 479, 482 (1965), and create statutory distinctions were none were intended.

American Tobacco v. Patterson, 456 U.S. 63, 72 n.6. (1982).

POINT II

Precedent Of This Court Sustains The Conclusion That The Purchase Of Shares Stock Of Continental By Ruefenacht Constituted The Purchase Of "Securities"

Petitioner's analysis of Supreme Court precedent (Pb15-Pb19) utterly fails to deal with the fact that this Court has never held shares of traditional stock not to be a security. The Court has dealt with a number of cases arising under the federal securities statutes in the fifty years since their enactment. Not once in any of those decisions which involved instruments possessing the atributes of traditional stock has the Court ever embarked upon a preliminary analysis of the transaction before applying the relevant law in such cases. Rather, consideration of the economic circumstances of the exchange transaction has been limited to novel or uncommon instruments that do not fall within any of the specifically enumerated categories of "security".

The petitioner contends that the sale of business doctrine was "explicitly" adopted by this Court in ***United Housing Foundation, Inc. v. Forman,*** 421 U.S. 837 (1975) (Pb17). In fact *Forman* does not provide support for that dubious doctrine. Rather, that decision and those which have followed it specifically undercut any such theory.

In *Forman,* plaintiffs contended that they had been induced by certain misrepresentations to purchase what were referred to as "shares of stock" in state-subsidized cooperative apartments known as "Co-Op City". They brought actions under the federal securities laws for rescission and damages. The Court, in a two part opinion, first rejected plaintiffs' argument that the shares in a cooperative apartment complex constituted securities within the meaning of the 1934 Act, 15 U.S.C. § 78c(a)(10), ruling that the mere labeling of interests as "stock" did not invoke the antifraud protection afforded by federal law.

> We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called 'stock', must be considered a security transaction simply because the statutory definition of a security includes the words 'any . . . stock'. 421 U.S. at 848.

In making that statement, however, this Court did not conclude that a transaction which involved traditional stock (such as the shares which Ruefenacht purchased) was not a securities transaction, but rather, was differentiating stock in the traditional sense from an interest

which was not in fact stock, although labeled as such. In fact, the Court noted:

> There may be occasions when the use of a traditional name such as 'stocks' or 'bonds' will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument. 421 U.S. at 850-851.

In determining that the tenants' interest in the co-operative apartments was not stock in the traditional sense, this Court observed:

> These shares have none of the characteristics 'that in our commercial world would fall within the ordinary concept of a security.' (Citation omitted). Despite their name, they lack what the court in *Tcherepnin* deemed the most common feature of stock: the right to received 'dividends contingent upon an apportionment of profits' (citation omitted). Nor do they possess the other characteristics traditionally associated with stock: they are not negotiable; they cannot be pledged or hypothecated; they confer no voting rights in proportion to the number of shares owned; and they cannot appreciate in value. In short, the inducement to purchase was solely to acquire subsidized low cost living space; it was not to invest for profit. 421 U.S. at 851.

In short, the first part of *Forman* (part II, A) constituted a finding by this Court not that actual, traditional stock such as that purchased by Ruefenacht was not a security, but rather, that the shares in the co-op were not "stock". In contrast, the shares of stock purchased by Ruefenacht have all of those attributes the *Forman* Court found normally associated with traditional stock. Had the Court in *Forman* been faced with the issue posed

in the case *sub judice,* it undoubtedly would have ended the inquiry at this point and held that the federal securities laws were applicable in conformance with *S.E.C. v. C.M. Joiner Leasing Corp.,* 320 U.S. 344, 355 (1943).

Having determined that the shares of the co-op were not "stock", and therefore not automatically securities as a matter of definition, the Court in *Forman* dealt with the plaintiffs' alternative argument that the instrument which was issued and sold constituted an investment contract, another type of security listed in the definition. *Forman,* 421 U.S. at 851-58 (part II, B). This Court restated the test for determining the existence of an investment contract as: "'whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.'" *Forman,* 421 U.S. at 852 (quoting *S.E.C. v. W.J. Howey Co.,* 328 U.S. 293, 301 (1946)). Based upon the *Howey* criteria, this Court found that no investment contract was present because the co-operative was a non-profit venture and therefore failed to meet the second part of the three part *Howey* test, *i.e.,* a profit motive. *Id.* at 301. This Court applied the *Howey* test, however, only after determining that the shares were not traditional stock.

Quite clearly then, if an instrument specifically named and defined as a security carries the traditional attributes of that instrument, nothing more is necessary to qualify under the 1933 and 1934 Acts. It is only when the instrument in question, or the transaction itself if there is no specific instrument, does not fall into any of the specifically delineated categories that a test must be invoked to determine whether it falls within a general catch-all cate-

gory such as "investment contract". Petitioner's suggestion that the catch-all terms should be construed as modifiers of the specific terms requiring application of the *Howey* test to all instruments flies in the face of *Joiner,* 320 U.S. 344, 350 (1943), and *Tcherepnin v. Knight,* 389 U.S. 332, 343 (1967). *See also* Note, *Repudiating The Sale-Of-Business Doctrine,* 83 Colum. L.Rev. 1718, 1732 n.106 (1983). As Professor Loss has observed:

> It is one thing to say that the typical cooperative apartment dweller has bought a home, not a security; or that not every installment purchase 'note' is a security; or that a person who charges a restaurant meal by signing his credit card slip is not selling a security even though his signature is an 'evidence of indebtedness.' But *stock* (except for the residential wrinkle) is so quintessentially a security as to foreclose further analysis. (Emphasis in original).

L. Loss, *Fundamentals of Securities Registration,* 212 (1983).

This Court has consistently resorted to the *Howey* test in determining whether an investment contract exists only in those transactions which dealt with unusual or unconventional instruments which did not fall into any of the specific definitional categories.[6] Respondent's analysis

---

[6]*Tcherepnin,* 389 U.S. 332 (involving withdrawable capital shares of a savings and loan association); *S.E.C. v. United Benefit Life Ins. Co.,* 387 U.S. 202 (1967), (involving combined variable fixed annuities); *S.E.C. v. Variable Annuity Life Ins. Co.,* 359 U.S. 65 (1959), (involving variable annunity contract); *Howey,* 328 U.S. 293 (involving the sale of citrus acreage coupled with optional service contracts to cultivate crops); *Joiner,* 320 U.S. 344 (involving sales of assignments of oil leases); *International Brotherhood of Teamsters v. Daniel,* 439 U.S. 551 (1979) (involving a non-contributory, compulsory pension plan).

of Supreme Court precedent as set forth above, is hardly novel. It accords with decisions in four courts of appeal in addition to that under appeal here and various commentators. *Coffin v. Polishing Machines, Inc.,* 596 F.2d 1202 (4th Cir. 1979), *cert. denied,* 444 U.S. 868 (1979); *Golden v. Garafalo,* 678 F.2d 1139 (2d Cir. 1982); *Seagrave Corp. v. Vista Resources, Inc.,* 696 F.2d 227 (2d Cir. 1982), *cert. granted,* 104 S.Ct. 2341 (1984), *cert. dismissed,* 105 S.Ct. 23 (1984); *Daily v. Morgan,* 701 F.2d 496 (5th Cir. 1983); *Cole v. PPG Industries, Inc.,* 680 F.2d 549 (8th Cir. 1982); Note, *Repudiating The Sale-Of-Business Doctrine,* 83 Colum. L.Rev. 1718, 1732 n.106 (1983); Carson, *Applications Of The Federal Securities Acts To The Sale Of A Closely Held Corporation By Stock Transfer,* 36 Me. L.Rev. 1, 23-38 (1984).

As petitioner contends, there is a contrary view expressed by four circuits. This view, known as the sale of business doctrine was first defined in *Fredericksen v. Poloway,* 637 F.2d 1147 (7th Cir. 1981), *cert. denied,* 451 U.S. 1017 (1981). The Seventh Circuit held that under *Forman* when the purchase of stock actually involves the purchase and assumption of control of an entire business, the transaction does not involve a "security" within the meaning of the federal securities laws. This was based on the assertion that the "economic reality" of the transaction is commercial, the acquisition of the business with the intent to manage, rather than investment. The Seventh Circuit continued that view in *Canfield v. Rapp & Son, Inc.,* 654 F.2d 459 (7th Cir. 1981), and *Sutter v. Groen,* 687 F.2d 197 (7th Cir. 1981). Recently, however, while not specifically disclaiming allegiance to *Sutter,* that

same circuit in *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984) observed:

> Of the two points RBC maintains are correct, the weakest one appears to be the point that every instrument must independently pass the investment contract test in order to be a security, RBC's principal support for this point is a single statement in Forman to the effect that the investment contract test 'embodies the essential attributes that run through all the Court's decisions defining a security.' In this statement, however, the Court merely identified a characteristic of its past decisions, all of which involved an unusual instrument not easily placed within the ambit of the other terms enumerated in the definitional sections of the securities acts. . . . An additional reason militates against the finding that the investment contract criteria apply to all securities. In Forman itself the Court initially considered whether respondents' shares could be 'stock' as the term is used in Section 2(1) of the Securities Act of 1933. In this section of the opinion, the court did not apply the investment contract test. Only after the court rejected respondents' characterization of their shares as 'stock' did the court look to the investment contract test. The implication that follows from the organization of the court's opinion is that the test articulated in Howey only determines whether an instrument is an 'investment contract,' a separate statutory term in the definitional section of the securities acts; an instrument that does not pass the investment contract test may still be a security if it falls under one of the other specific satutory terms. 745 F.2d at 491.

The court further stated:

> The investment contract test determines whether a particular instrument is an 'investment contract,' a distinct term in the definitional sections of the securities act. An instrument that fails to satisfy all four requirements of the investment contract test may still fall under one of the other statutory terms in the definitional section and hence be subject to the substantive provisions of the acts. 745 F.2d at 492.

As observed even by the Seventh Circuit in *Hunssinger* those circuits which have adopted the sale of business doctrine confuse the two part nature of *Forman* and, for some reason, apply the *Howey* test to traditional shares of stock. In doing so, they conclude that unless the purchaser of stock acquires it with the intent that he achieve profits from the efforts of others, his stock somehow is not really a security.

By way of example, *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982), involved the sale of all of the stock of a corporation. The Eleventh Circuit observed that "the stock transferred in this case clearly has all the characteristics that fit the ordinary conception of a security". 673 F.2d at 344. Rather than abiding by the first part of the *Forman* test, and concluding that the stock was a security within the meaning of the federal securities laws, the court turned to the second half of the *Forman* opinion observing:

> Based on the rationale of Forman, we reject a literal test and hold that the 'economic realities' test is appropriate to determine whether a transaction involving stock in a corporation is a 'security transaction' or an 'investment contract' governed by the Federal Securities Acts.

673 F.2d at 344-345.

The fallacy of this argument is that traditional stock is not, nor need it be, an investment contract. They are two separate things. The fact that one of the elements

of an investment contract was absent in *Winkler* is wholly irrelevant. Since the instrument qualified as a security under the first part of the *Forman* test by being traditional stock, there was no need to fall back on the investment contract theory as the plaintiffs were forced to do in *Forman.*

Recently, this Court again followed the procedure first laid down in *Joiner* and followed through *Tcherepnin, Forman* and *Daniel.* In *Marine Bank v. Weaver,* 455 U.S. 551 (1982), the plaintiffs guaranteed a bank loan and pledged a certificate of deposit as collateral for the guarantee. As consideration, the borrowers gave the plaintiffs the right to receive a percentage of the profits of the business owned by them, the right to use a barn and pasture belonging to the business and the right to veto future loans made to the borrowers. The plaintiffs contended that the bank fraudulently induced them to enter into the transaction and that that fraud constitued a violation of the federal securities laws. This Court was called upon to determine whether the certificate of deposit was a "security" or, alternatively, whether the private agreement between the plaintiff and the borrowers was a "security".

In arriving at its decision that no security was involved, the Court followed the same two step test it had enunciated in *Forman.* First, it examined the statutory definition of a security and observed that while the term "certificate of deposit" was not found therein, there were other instruments named to which the certificate of deposit might be equivalent. In so doing, the Court clearly and unambiguously observed that the statutory definition

specifically "includes ordinary stocks and bonds, along with the 'countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.'" 455 U.S. at 556 (quoting *Howey,* 328 U.S. at 299). The Court went on to observe that if the certificate of deposit was the equivalent of any of the specifically named instruments, it would *automatically* qualify as a security 455 U.S. at 557-58.

Examining the instrument before it, the Court determined that the certificate of deposit was not, in fact, the same as any of the items specifically identified by the Act as securities, including, for example, a certificate of deposit for a security, a long term debt obligation, or withdrawable capital shares of a savings and loan association which the court observed "were much more like ordinary shares of stock and 'the ordinary concept of a security'. . . ." 455 U.S. at 557.

Having concluded that the certificate of deposit could not be equated with any of the specifically enumerated items which would automatically qualify it as a security (nowhere does the three part "economic reality" test rear its head in the first part of the *Weaver* decision), the Court embarked upon the second part of the two-part *Forman* test to deal with the plaintiffs' alternate contention that the agreement between him and the borrowers might be a "certificate of interest or participation in a profit sharing agreement" or an "investment contract" 455 U.S. at 599. Here, for the first time, the Court applied the *Howey* test and found on the basis of that test, that this particular agreement did not fall within the definition of either an investment contract or a profit sharing agreement. Ac-

cordingly, the agreement could not qualify as a security under any of the definitions of the 1934 Act.[7]

Ruefenacht's stock clearly carries the traditional attributes of that instrument. The shares entitled him to dividends contingent upon the apportionment of profits, *Tcherepnin,* 389 U.S. at 359, voting rights and all "other characteristics traditionally associated with stock". *Forman,* 421 U.S. at 851. In these circumstances, the precedent of this Court does not require, nor does it permit, the Court to look behind the name of the instrument specified in the statute.

POINT III

Policy Considerations Favor The Rejection Of The Sale Of Business Doctrine.

A. Uncertainty Of Application Requires The Rejection Of The Sale Of Business Doctrine.

One of the least attractive aspects of the sale of business doctrine is the difficulty, if not impossibility of defining and predicting its application. Petitioner insists that before the securities acts can be applied to any exchange of stock there first must be an analysis under the test established for investment contracts in *S.E.C. v. W.J. Howey Co.,* 328 U.S. 293 (1946), to determine whether "the scheme involves an investment of money in a common

---

[7]An additional factor was also involved in the Supreme Court's consideration of both of *Daniel* and *Weaver.* In *Daniel,* the Court reasoned that ERISA supplanted any necessity for coverage by the securities acts 439 U.S. at 569-70. The Court expanded on this theme in *Weaver,* holding that because the FDIC insured the certificate of deposit the FDIC supplanted any necessity for coverage under the securities laws. 455 U.S. at 558. No such regulatory schemes, however, apply in the sale of business context.

enterprise with profits to come solely from the efforts of others." *Id.* at 301. Determining whether the profits come "from the efforts of others" requires an evaluation of something called "control" in each instance. Whether control refers to intended control, exercised control or control which one is capable of exercising in any particular set of circumstances is not clear, nor has petitioner clearly articulated what control is to mean.

The suggestion by petitioner that "corporate control in a securities law context means the ability to influence corporate direction or policy" (Pb26 n. 12) is hardly helpful. Every shareholder in every corporation has some ability to influence corporate direction or policy. Even those who are not shareholders but who are employees of a corporation or, for that matter, people who are not associated with the corporation directly such as competitors, have the ability to influence the policy of the corporation.

Assuming that the type of control petitioner and other proponents of the sale of business doctrine require is some substantial degree of control, it is an arduous, if not impossible, task to define or predict what that control will be in any given transaction involving the exchange of stock. Ruefenacht's situation provides an example of the dilemma. Continental is a New Jersey corporation, and as such its affairs are governed by the statutory law of the State of New Jersey, specifically N.J. Stat. Ann. §14A:1-1 *et seq.* (West 1984). Under New Jersey law "the business and affairs of the corporation shall be managed by its Board [of Directors] . . ." N.J. Stat. Ann. §14A:6-1. At no time was Ruefenacht entitled to be more than one member of what was authorized to be a six-person

board and, as a result, was never entitled to more than one vote out of six. Further, even if a new board were elected, at best he could elect half of the board. The most he could do with half of the board would be to force a deadlock. N.J. Stat. Ann. § 14:A:12-7.[8] In short, as a 50% shareholder Ruefenacht could exercise no degree of control other than the ability to block the other 50% shareholder from acting unilaterally.

The suggestion by petitioner that there is nothing arbitrary or unpredictable about the application of the sale of business doctrine is absurd. He suggests that a hearing be held in each case to evaluate standards which have never been articulated and which probably are not capable of being articulated clearly (Pb29-Pb30). By way of example only, query: How does one define control then? How is it evaluated in a corporation utilizing staggered directorships? In a corporation where the purchaser has the ability to elect a new board of directors at some time in the future, does he have control? When does he acquire that control? What is the standard of control in corporations with cumulative voting or class voting? How do the super-majority voting provisions of certain state statutes effect the issue of "control"[9]? Far from reduc-

---

[8]Pursuant to New Jersey law a director cannot be removed prior to the expiration of his scheduled term absent a showing of good cause or absent a provision to the contrary in the Certificate of Incorporation. Nothing in the record in this case indicates any such provision in Continental's Certificate of Incorporation. N.J. Stat. Ann. § 14A:6-6. Even a removal for cause, however, requires the affirmative vote of a majority of the votes cast by the shareholders. Therefore, Ruefenacht could not even remove a director for cause without the acquiescence of Birkle.

[9]See e.g., Delaware law: Del. Code Ann. Tit. 8 § 102(b)(4) (1984) and *Atlantic Properties, Inc. v. Commissioner,* 519 F.2d 1233 (1st Cir. 1975).

ing the amount of Federal litigation as petitioner suggests the application of the sale of business doctrine will significantly increase the burden on the courts. In publicly traded corporations, holdings of far less than 50% of the outstanding stock may provide a certain ability to "control" depending upon the definition given to control. How is this factored into the equation? *See e.g., Essex Universal Corp. v. Yates,* 305 F.2d 572, 578-79 (2d Cir. 1962).

Beyond the issue of control is the artificial and further complicating issue of the "investor-entrepreneur" dichotomy in the sale of business doctrine. The application of that portion of the *Howey* test requiring that profits be derived from the efforts of others necessitates making a distinction between intent to invest and intent to manage, a line that cannot be easily drawn in terms of when the intent derives or changes, how much participation is permitted, etc. Nor is there any justification for suggesting that a person is less entitled to protection under the federal securities acts because he undertakes to perform services on behalf of the corporation for the purposes of protecting or enhancing the value of his investment. *See Ruefenacht v. O'Halloran,* 737 F.2d 320, 334 (3d Cir. 1984); Note, *Repudiating The Sale-Of-Business Doctrine,* 83 Colum. L.Rev. 1718, 1738-39 (1983). Further, any doctrine which turns on intent faces the problem that the intent of the purchaser may change either during or after the stock transaction. Since the questions of control and intent cannot be answered in the abstract and are not susceptible to a single hard definitional rule every case would involve a mini (or perhaps maxi) trial on those issues.

Finally, any doctrine which suggests that securities law coverage is not provided to one who acquires traditional stock with the intent to manage or control of necessity excludes from the reach of the anti-fraud provisions of the federal securities laws most if not all tender offer battles. When U.S. Steel purchased Marathon Oil the "economic reality" was that U.S. Steel would control, in fact dominate, the operation of the enterprise. Under the economic reality test this would not be a securities transaction. Surely such a result is not consistent either with the letter or spirit of the 1933 or 1934 Acts.

B. Special Risks Inherent In The Purchase Of Stock Dictate That Purchasers Of Stock Be Accorded The Protection Of The Federal Securities Laws.

Petitioner suggests that there is no need for the federal securities laws to provide protection to those who acquire controlling interests in a corporation because "as plaintiff-purchasers become increasingly able to protect themselves through control or influence over the enterprise, and concomitantly less dependent upon others for a return of profit, such persons progressively become less in need of securities law protection and hence less reason exists to extend coverage to them." (Pb27). Such a position ignores the fact that the damage from a fraudulent sale of stock occurs at the time the transaction occurs, before the purchaser takes "control".

Customarily, one who acquires the assets of a corporation but not its liabilities can shield himself from liability to the corporation's creditors. Such protection is not available to one who acquires the stock of a corporation

since the entity remains subject to its liabilities. The need for federal securities law protection is particularly acute when, as the Fifth Circuit observed in *Daily v. Morgan*, 701 F.2d 496, 502 (5th Cir. 1983):

> [T]here are special risks involved in the sale of stock in a corporation that might justify special protection. Generally speaking, one who purchases the assets of a business is not liable for its debts and liabilities, while one who purchases the stock in a corporation—a separate legal entity—assumes ownership of a business with both assets and liabilities [citations omitted]. Liabilities, alas, are often the subject of inaccurate or incomplete disclosures.

701 F.2d at 504. *See also Ruefenacht*, 737 F.2d at 333.

While, of course, it is possible for a purchaser of a "controlling" interest in a corporation to reduce certain risks by employing attorneys and accountants to comb through every detail and aspect of the seller's business, such an investigation is costly and even the best, most expensive audit is susceptible to the deception of the seller. Further, there exists no justification to impose the economic burden of such examinations and investigations on an investor who acquires "control", and not upon one who does not. Certainly it may be possible to acquire "control" of one corporation in a transaction involving the purchase of stock for $10,000 and not to acquire "control" when purchasing one million dollars' or more worth of stock in another corporation. Accordingly, any suggestion that there are more dollars at stake in an acquisition involving control is fallacious.

C. The Employment Of The Sale Of Business Doctrine Would Deprive A Purchaser Of Stock Of The Justifiable Expectations And Benefit Of His Bargain.

By choosing to deal in the transfer of stock as opposed to a sale of assets, the parties operated under the presumption that the federal securities laws should apply. As this Court observed in *United States Housing Foundation, Inc. v. Forman,* 421 U.S. 837, 850-51 (1975):

> There may be occasions when the use of a traditional name such as 'stocks' or 'bonds' will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

Thus, the reliance of the buyer and his attorney upon the understanding that the anti-fraud provisions of the federal securities laws will protect them is justified, particularly where the stock purchased exhibited the characteristics of traditional stock such as those purchased by Ruefenacht. Accepting petitioner's view would eliminate the protection for which the parties bargained from the purview of the statute.

D. The Anti-Fraud Provisions Of The Federal Securities Laws Are Intended To Provide Protection To Purchasers Of All Securities, Whether Or Not Registered.

The language of the very anti-fraud provisions of the federal securities laws under which Ruefenacht seeks redress evinces an intention to protect purchasers of unregistered as well as registered securities. Section 10(b) of the 1934 Act prohibits the use of manipulative or deceptive devices "in connection with the purchase or sale of any security registered on a national securities exchange *or any security not so registered. . . .*" (Emphasis added) 15 U.S.C. §78j(b). Certainly, if Congress had intended to exempt the sale of controlling interests in closely held corporations from the anti-fraud provisions it could have done so. Congress was able to exempt many securities transactions from other requirements of the securities laws when it chose to, but mandated that the anti-fraud provisions of Sections 10(b) of the 1934 Act and 12(2) of the 1933 Act apply to private as well as public securities transactions. Clearly, the purpose of the federal securities laws is to protect purchasers of all securities, not just those in publicly traded corporations. This Court set any contrary argument to rest more than a decade ago when it stated:

> . . . we do not read Section 10(b) as narrowly as the Court of Appeals; it is not 'limited to preserving the integrity of the securities markets' (430 F.2d at 361), though that purpose is included. Section 10(b) must be read flexibly, not technically and restrictively.
>
> • • •
>
> . . . we read Section 10(b) to mean that Congress wanted to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face.

Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

Courts which support the sale of business doctrine seek to confine the protection of the securities laws to shareholders of publicly traded corporations in spite of the specific language of *Bankers Life. See e.g., Sutter v. Groen,* 687 F.2d 197 (7th Cir. 1982) and petitioner's brief at 26-27. As Professor Loss has observed, "one difficulty

with the negative view in the sale-of-business case is that it comes dangerously close to the heresy of saying that the fraud provisions do not apply to private transactions; . . . ." L. Loss, *Fundamentals of Securities Regulation,* 212 (1983).

E. The Existence Of State Law Protection Should Not Justify The Adoption Of The Sale Of Business Doctrine.

The suggestion that the purchaser or seller of shares constituting a "controlling interest" in a corporation should not require protection of the federal securities laws because there are state remedies for fraud does not justify the adoption of the sale of business doctrine.

The argument that common law remedies are adequate to protect a purchaser simply is not true. For example, the seller may not be solvent and it may not be possible for the purchaser to proceed under state law against all possible defendants because of the existence of privity requirements under state, but not federal, securities laws.

Additionally, there is nothing in the federal securities laws which suggests that they apply only in the absence of an adequate common law remedy. Quite the contrary, the 1933 Act explicitly states: "The rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. §77p.[10] Further, this Court has

[10]See Note, *Repudiating The Sale-Of-Business Doctrine,* 83 Colum. L.Rev. 1718, 1739 n. 152, 1742 (1983) as to additional benefits conferred on victims of fraud by the securities acts.

always emphasized the remedial characteristics of the federal securities laws. *See Tcherepnin v. Knight,* 389 U.S. 332, 336 (1967).

Accordingly, there is no justification to suggest that the adequacy of a state remedy serves as a justification for the adoption of the sale of business doctrine.

F. The Adoption Of The Sale Of Business Doctrine Would Create Unfair And Arbitrary Distinctions.

A rule which directs that a defrauded purchaser of 51% of the stock of a corporation has no federal remedy, whereas his partner who acquired 49% has such a remedy, is unfair, unreasonable and arbitrary. It makes no sense that the sale of all of a corporation's stock to a single buyer by a single seller constitutes the sale of a security but the same sale to a single buyer by several sellers, each of whom did not formally exercise control, does not.[11] Further, it makes no sense that a series of stock sales each in and of itself insufficient to transfer control from a single seller to a single purchaser constitutes the sale of securities, but that the final sale (that which pushes the purchaser over the level of "control", whatever that level may be) does not. Clearly there was no greater or less fraud in connection with the sale to the 51% partner than there was in the 49% transaction, nor was the fraud any more monstrous in the tenth sale to the same purchaser than it was in the first nine.

[11]*McGrath v. Zenith Radio Corp.,* 651 F.2d 458, 467 n.5 (7th Cir. 1981), *cert. denied,* 454 U.S. 835 (1981).

There is no justification for telling a defrauded purchaser that he has no federal remedy merely because he participated in the operation of the business, whereas if he had been a passive investor he would have had a cause of action for the very same fraud. If such were the law, no employee purchasing stock of a corporation by which he is employed would be protected under the federal securities laws.

In *Sutter v. Groen,* 687 F.2d 197 (7th Cir. 1982), the court in explanation of its adherence to the sale of business doctrine, discussed the difference between a "investor", whom the securities laws would protect, and "entrepreneur" who would not have that benefit:

> There is a clear difference in principle between an investor and an entrepreneur; and while sometimes a person is both at once, often he is one or the other. A judge who owns IBM stock is an investor but not an entrepreneur; the corner grocer is a food entrepreneur rather than an investor in the food business, though a conglomerate corporation that owned a chain of grocery stores might be both.

687 F.2d at 201. What is the standard of fairness that provides the billion-dollar conglomerate which purchases the stock of a "mom and pop" grocery store with the protection of the federal securities laws, but denies that protection to the same mom and pop who purchase a store from the conglomerate? And what is to happen to "investors" who become "participants" after the purchase takes place?

The sale of business doctrine would require making arbitrary distinctions which would impute a chameleon-like quality to stock unintended by Congress. The unpredictability and arbitrariness which the doctrine would inflict on the commercial world must be avoided.

CONCLUSION

For all of the foregoing reasons it is respectfully requested that the decision of the Court of Appeals for the Third Circuit to reverse the dismissal of the respondent's federal securities laws claims be affirmed.

Respectfully submitted,

PETER S. PEARLMAN
COHN & LIFLAND, ESQS.
Park 80 Plaza West One
Saddle Brook, New Jersey 07662
(201) 845-9600
Attorney for Respondent
Max A. Ruefenacht

DATED: January 29, 1985

On the Brief

JEFFREY W. HERRMANN
PETER S. PEARLMAN
ANN M. DOUGHERTY

No. 84-165

In the Supreme Court of the United States

OCTOBER TERM, 1984

W. GEORGE GOULD, PETITIONER

v.

MAX A. RUEFENACHT, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE SUPPORTING RESPONDENT

REX E. LEE
Solicitor General

LOUIS F. CLAIBORNE
Deputy Solicitor General

CHRISTOPHER J. WRIGHT
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

ROSALIND C. COHEN
Assistant General Counsel

STEPHEN M. DETORE
Attorney
Securities and Exchange Commission
Washington, D.C. 20549

QUESTION PRESENTED

Whether the sale of a 50% stock interest in a company is a securities transaction subject to the antifraud provisions of the federal securities laws.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases—Continued: Page

Statutes and regulation:

Miscellaneous:

Miscellaneous—Continued: Page

In the Supreme Court of the United States

OCTOBER TERM, 1984

No. 84-165

W. GEORGE GOULD, PETITIONER

v.

MAX A. RUEFENACHT, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE SUPPORTING RESPONDENT

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission submits this brief as amicus curiae to address a significant issue under the federal securities laws—whether the sale of conventional stock in a business corporation is excluded from the coverage of those laws where the purchaser acquires a degree of control over the corporation. The Third Circuit held that conventional stock necessarily is a "security," and, hence, that a transaction involving such stock is covered by the antifraud provisions of the securities laws, regardless of whether there is a transfer of control. That court thereby joined the Courts of Appeals for the Second, Fourth, and Fifth Circuits in rejecting the "sale of

business" doctrine,[1] which has been adopted by four other circuits.[2]

The Commission agrees with the analysis and conclusion of the court below. While the present case involves the transfer of a 50% stock interest, it raises the same concerns as its companion case, *Landreth Timber Company* v. *Landreth*, cert. granted, No. 83-1961 (Nov. 13, 1984), which involves the transfer of a 100% stock interest. As we urged in our amicus curiae brief in *Landreth*, where a person is defrauded in the purchase or sale of a well-defined instrument that is enumerated in the statutory definitions of "security" in the federal securities laws, the availability of a cause of action under the antifraud provisions of those laws should not turn on questions of control. Regardless of the percentage purchased or sold, persons who choose to deal in instruments such as conventional stock and bonds should be able to know—without a hearing—that the antifraud provisions of those laws are applicable. Neither the Commission, in enforcing the antifraud provisions, nor defrauded private parties should be required to litigate whether conventional debt or equity securities also meet the test for securities in the form of investment contracts.

---

[1] *Golden* v. *Garafalo*, 678 F.2d 1139 (2d Cir. 1982); *Coffin* v. *Polishing Machines, Inc.*, 596 F.2d 1202 (4th Cir.), cert. denied, 444 U.S. 868 (1979); *Daily* v. *Morgan*, 701 F.2d 496 (5th Cir. 1983); see also *Cole* v. *PPG Industries, Inc.*, 680 F.2d 549 (8th Cir. 1982) (interpreting Arkansas law by reference to the federal securities laws).

[2] *Landreth Timber Co.* v. *Landreth*, 731 F.2d 1348 (9th Cir.), cert. granted, No. 83-1961 (Nov. 13, 1984); *Sutter* v. *Groen*, 687 F.2d 197 (7th Cir. 1982); *King* v. *Winkler*, 673 F.2d 342 (11th Cir. 1982); *Chandler* v. *Kew, Inc.*, 691 F.2d 443 (10th Cir. 1977).

STATEMENT

In early 1980, respondent Max A. Ruefenacht purchased 2,500 shares of newly issued common stock of Continental Import and Export, Inc., thereby becoming a 50% shareholder in the company (Pet. App. 5a). Prior to the transaction, Joachim Birkle, Birkle's wife, and a company that Birkle controlled were Continental's sole shareholders (Pet. App. 5a; Amended Complaint ¶ 5C). Following his purchase of the stock, respondent took an active although part-time role in Continental's affairs, while remaining a full-time employee of another company (Pet. App. 6a). Birkle remained Continental's president (Pet. App. 5a).

Respondent brought this action under the antifraud provisions of the federal securities laws,[3] alleging that he had purchased the Continental stock in reliance on misrepresentations concerning the company's financial condition, projected earnings, and material contracts (Pet. App. 6a-7a). Petitioner W. George Gould, Continental's counsel and a director of the company, was named as one of the defendants (Amended Complaint ¶ 5E). Following an evidentiary hearing on the extent of the control respondent acquired in connection with the stock purchase, the district court entered summary judgment for the defendants on the basis of the sale of business doctrine (Pet. App. 46a-47a, 51a-52a). In the view of that court, respondent's

---

[3] The antifraud provisions relied upon by respondent are Sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. 77*l*(2) and 77q(a), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. Respondent also alleged claims under 15 U.S.C. 77*l*(1) based on registration violations, and he alleged pendent state law claims as well.

purchase of Continental stock was not a securities transaction because the stock failed to meet the test for a security in the form of an investment contract —in particular, the requirement that profits from the enterprise be derived from the efforts of others (Pet. App. 48a).

The court of appeals reversed. It held that the investment contract test does not apply to conventional common stock. Characterizing stock as a "well-defined" term, the court concluded (Pet. App. 42a; see *id.* at 23a) that the sale of business doctrine is contrary to the language, structure, and legislative history of the securities laws, is inconsistent with underlying policy, and derives from a misunderstanding of *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975).

SUMMARY OF ARGUMENT

I.

The sale of business doctrine conflicts with the language of the federal securities laws, their structure, and their legislative history. Petitioner seeks to excise from the definition of "security" in the securities laws the quintessential security, common stock in a business corporation, and to engraft onto the statute a new requirement—that each transaction involve an investment in a common enterprise with profits to be derived from the efforts of others. This proposed exercise in judicial legislation disregards the statutory language, which enumerates a variety of financial instruments, including "stock," as securities. Petitioner's analysis also conflicts with the legislative scheme, which regulates private transactions and transfers of corporate control. Moreover, the legislative history demonstrates that in enacting the securities laws, congressional concern was not limited to the protection of "passive" investors. Thus, there is no warrant in the legislative record for excluding purchasers of conventional securities simply because they are able to obtain information concerning the corporation or intend to play a subsequent role in corporate management.

II.

The sale of business doctrine finds no support in this Court's prior decisions. While the Court has used a transactional test in determining whether the securities laws apply to instruments of an unusual nature, it has not suggested that such a test is required in the case of conventional instruments. *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975), makes clear that purchasers of instruments bearing traditional names such as stock, and embodying significant characteristics associated with those instruments, may reasonably rely on the applicability of the federal securities laws. Nor does this Court's decision in *Marine Bank* v. *Weaver*, 455 U.S. 551 (1982), support the sale of business doctrine. The Court in that case relied on the language "unless the context otherwise requires," which precedes the definitional sections of the securities laws, in excluding a certificate of deposit—an instrument covered by comprehensive federal banking laws—from the antifraud provisions of the securities laws. This case, in contrast, involves stock, which is not covered by another federal regulatory scheme.

III.

Nor do policy considerations favor the sale of business doctrine. Adopting that doctrine would generate wasteful litigation directed to the threshold issue of

what constitutes a security in each particular factual setting, engender uncertainty in the application of the law and create arbitrary and unfair results. It might also call into question the status of other instruments, including debt obligations, that have always been considered securities. Finally, significant legal distinctions between sales of stock and sales of assets support the conclusion that purchasers of stock have the protections of the antifraud provisions of the securities laws.

ARGUMENT

Petitioner posits that, in enacting the federal securities laws, Congress intended principally to protect "passive" investors and that, accordingly, this Court should limit the coverage of those laws to advance that purpose only. To this end, petitioner asks the Court to adopt, as the exclusive definition for all securities, the test designed to identify "investment contracts," one of the many types of instruments enumerated in the statutory definition of "security." The exercise in judicial legislation which petitioner proposes would require the Court to disregard the plain statutory language, misconstrue the legislative history, and ignore its prior decisions construing those statutes, in order to reach a result that is unsound as a matter of policy.

I. THE SALE OF BUSINESS DOCTRINE IS CONTRARY TO THE LANGUAGE, STRUCTURE, AND LEGISLATIVE HISTORY OF THE FEDERAL SECURITIES LAWS

A. "Security," as defined in Section 2(1) of the Securities Act of 1933, 15 U.S.C. 77b(1), and in Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), includes both specific

terms, such as "stock," and more general terms, such as "investment contract."[4] See *SEC* v. *W. J. Howey Co.*, 328 U.S. 293, 297-299 (1946). As discussed in the Brief of the Securities and Exchange Commission as Amicus Curiae Supporting Petitioner (at 7 11), in *Landreth Timber Company* v. *Landreth*, No. 83-1961 [hereinafter cited as SEC Landreth Br.], to use the test for "investment contract"[5] to determine the status under the securities laws of "stock"—a separate term in the definition—violates established canons of statutory construction. As the court below correctly recognized, the notion that a catch-all statutory term like "investment contract"—designed to *broaden* the Acts' coverage by ensuring that novel, unconventional or irregular instruments would come within the concept of a security—instead *circumscribes* the more specific term "stock," "turn[s] the

---

[4] Section 3(a)(10) of the Securities Exchange Act provides:

> The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement, * * * investment contract, voting-trust certificate, * * * or in general, any instrument commonly known as a "security" * * *.

Section 2(1) of the Securities Act is virtually identical. See *Marine Bank* v. *Weaver*, 455 U.S. 551, 555 n.3 (1982). All 40 definitions in the Securities Exchange Act, and all 15 definitions in the Securities Act, are preceded by the phrase, "When used in this [chapter], unless the context otherwise requires * * *" (see pp. 15-16, *infra*).

[5] The Court in *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852 (1975), defined an investment contract as "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."

history of the Acts * * * on their heads" (Pet. App. 22a).[6]

In urging the use of a test that looks to the character of the transaction, rather than the nature of the instruments, petitioner erroneously attempts (Br. 22-23) to analogize "stock"—a specific and precise term in the statutory definition—to "note"—a vague term capable of referring to a variety of commercial, consumer, and investment instruments. See SEC Landreth Br. at 10-11. As the court below correctly observed, "there is * * * some necessity for fine-tuning the definition of 'note' to avoid sweeping within the coverage of section 10(b) of the 1934 Act every consumer and business loan financing current operational costs. But there is no such necessity in the stock area" (Pet. App. 13a-14a). Once a court determines that instruments are conventional stock, "the paradigm of a security" (*Daily* v. *Morgan*, 701 F.2d at 500), it should end its inquiry and hold that the instruments are securities.

B. There is little need to speculate about congressional intent. Even apart from the definitional sections, the federal securities laws themselves refute the fundamental premise underlying the sale of business doctrine—that private, negotiated transactions and transfers of corporate control are outside the intent of those statutes.

---

[6] This Court has repeatedly declined invitations to restrict the meaning of the Acts' general terms because of the more specific terms such as "stock" that precede them. *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 350-351 (1943); *Tcherepnin* v. *Knight*, 389 U.S. 332, 343 (1967). By incorporating the "investment contract" analysis into the proposed test for determining whether "stock" is a "security," petitioner seeks essentially to swallow the specific terms into the general.

Congress considered private transactions in connection with the Securities Act of 1933. Rather than omit them from the coverage of that Act, as petitioner implies (Br. 24-25), Congress chose to strike a balance between the need for antifraud protection and the desire to minimize the burden on the transacting parties. Thus, the drafters of the Securities Act expressly exempted private, negotiated transactions from the registration provisions, but not from the antifraud provisions. See Sections 4, 12(2), and 17(a) of the Securities Act, 15 U.S.C. 77d, 77*l*(2), 77q(a). The Securities Exchange Act reflects a similar judgment. See Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b); *Daily* v. *Morgan*, 701 F.2d 496, 502 (5th Cir. 1983) ("Congress * * * chose to apply the section 10(b) antifraud provision to all stock" without exempting small, private sales). Accordingly, "the Act has always been understood to apply to transactions in shares of close as well as publicly held corporations and to negotiated as well as market sales and purchases of shares." *Golden* v. *Garafalo*, 678 F.2d 1139, 1146-1147 (2d Cir. 1982) (citing *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 10 (1971)); see *Marine Bank* v. *Weaver*, 455 U.S. 551, 556 (1982).

Contrary to the tenor of petitioner's position (Br. 13), the Securities Exchange Act includes provisions directed to the transfer of controlling stock interests. For example, the Act expressly provides for the regulation of tender offers (transactions designed to acquire corporate control), for the disclosure of transactions by persons who control corporations (such as directors, officers, and principal stockholders), and for the recovery of short-swing profits garnered by such persons. See, *e.g.*, Sections 14 and 16 of the Securities

Exchange Act, 15 U.S.C. 78n and 78p. Petitioner cannot contend that these provisions should be read out of the statute on the ground that they deal with a subject matter of no interest to Congress. These provisions show that, in fact, petitioner misunderstands the scope of the securities laws.[7]

C. The legislative history of the federal securities laws likewise provides no justification for the sale of business doctrine. See SEC Landreth Br. at 13-14. While petitioner correctly points out (Br. 8) that Congress was concerned with the protection of investors, this Court recognized in *United States* v. *Naftalin*, 441 U.S. 768, 776 (1979), that this was by no means Congress' sole concern. Rather, the report of the Senate Committee on Banking and Currency recited a number of legislative goals for the 1933

---

[7] Because private transactions and those affecting corporate control are expressly covered by provisions of the Securities Exchange Act, they are clearly within the "public interest" advanced by the antifraud provisions of Section 10(b). See Br. 21. Furthermore, petitioner's suggestion (Br. 21) that that term should be narrowly construed ignores half a century of judicial construction holding that Section 10(b) and Rule 10b-5 "should be construed 'not technically and restrictively, but flexibly to effect [their] remedial purposes.'" *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 386-387 (1983) (quoting *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)).

Likewise, the placement of Section 10(b) (15 U.S.C. 78j(b)) between Section 9 (15 U.S.C. 78i), prohibiting manipulative activities on national securities exchanges, and Section 11 (15 U.S.C. 78k), prohibiting certain trading by brokers, dealers, and exchanges, in no way demonstrates that Section 10(b) covers only these same persons and activities. See Br. 21 n.8. To the contrary, Section 10(b) is expressly concerned with "any security registered on a national securities exchange or any security not so registered * * *."

Act.[8] Moreover, petitioner's characterization of the term "investor" as synonymous with "passive investor" (Br. 13) conflicts with common usage. To "invest" means simply "[t]o lay out (money or capital) in business with the view of obtaining an income or profit; to convert into some form of wealth other than money, as securities or real estate, with the expectation of dividends, rentals, etc.; as to *invest* money in stocks." *Websters' New International Dictionary of the English Language* 1306 (2d ed. 1934) (emphasis in original); accord, Funk & Wagnalls, *New Standard Dictionary of the English Language* 1289 (1932). This definition does not exclude those whom petitioner refers to as "entrepreneurs."

Nor does the legislative history support petitioner's theory (Br. 13) that Congress intended to protect purchasers of conventional securities only if (1) they cannot "obtain or confirm relevant firsthand information" about the business; and (2) they must rely "virtually entirely upon others for management of the enterprise." The first prong of petitioner's proposed test would probably exclude persons who purchase se-

---

[8] The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

S. Rep. 47, 73d Cong., 1st Sess. 1 (1933).

curities through brokerage firms having research departments, as well as virtually every institutional investor, regardless of the size of its investment. The second prong, which looks to events subsequent to the purchase, is equally inapposite. By the time a defrauded purchaser obtains a voice in corporate management, any false representation has achieved its purpose—the purchaser has already invested his money. The fraud respondent alleges was "in connection with" his stock purchase and related to the condition of the corporation and the value of its shares at the time of purchase. At that time, he had no control over the corporation or its policies. Furthermore, the possibility of fraud is not eliminated simply because a person buys or sells a controlling stock interest. Nor is a purchaser of a controlling interest necessarily able to "mitigat[e] the effects of fraud" (Br. 13). Indeed, the size of such a purchase may instead exacerbate the effects of fraud.

II. PRIOR DECISIONS OF THIS COURT DICTATE REJECTION OF THE SALE OF BUSINESS DOCTRINE

Far from validating the major exercise in judicial legislation needed to uphold petitioner's position (see Br. 15), prior decisions of this Court—like the structure of the statutes and their legislative history—counsel deference to the statutory language. As this Court acknowledged in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 199 n.19 (1976) (quoting *Addison* v. *Holly Hill Fruit Products, Inc.*, 322 U.S. 607, 617-618 (1944)):

> To let general words draw nourishment from their purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another. * * * After all, legislation when not expressed in technical terms is addressed to the common run of men and is therefore to be understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him.

To deny that conventional stock is a security requires a departure from the words of the statute that no decision of this Court suggests.

A. Petitioner claims that this Court's past decisions support the use of the investment contract test in cases involving conventional common stock. But the Court's inquiries into the definition of a security have all concerned "unusual" instruments (*Marine Bank* v. *Weaver*, 455 U.S. at 559). See SEC Landreth Br. at 18-19 & n.18. While it was necessary to apply a transactional test to determine whether these unusual instruments were securities, the decisions do not suggest that such time-consuming analysis is either requisite or useful in the case of more conventional instruments. To the contrary, this Court has suggested that, in some cases, "proving the document itself, which on its face would be a note, a bond, or a share of stock" will establish coverage. *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943). Furthermore, a purchaser may justifiably assume that the federal securities laws apply when the instrument bears a traditional name such as "stock" or "bonds" and "embodies some of the significant characteristics typically associated with the named instrument." *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 850-851 (1975).

This is just such a case. Unlike the cooperative housing "stock" at issue in *Forman*, the stock purchased by respondent embodies the indicia typically associated with stock: (1) "the right to receive

'dividends contingent upon an apportionment of profits' "; (2) negotiability; (3) the ability to be used as collateral; (4) "voting rights in proportion to the number of shares owned"; and (5) share appreciation. *Id.* at 851 (citation omitted); Pet. App. 7a.[9] The purchaser of such instruments would regard them as stock precisely because in "economic reality" they are stock.

Seizing on language in *Forman*, petitioner erroneously asserts (Br. 31-32) that controlling shareholders "use or consume" the corporation's assets. While the purchaser of so-called stock for the purpose of obtaining living quarters, as in *Forman*, clearly intends to "use or consume" his purchase (*Forman*, 421 U.S. at 853), a purchaser of stock in a business corporation clearly does not.[10] By its nature, conventional stock—

---

[9] The district court rejected the argument that "because Continental is a closed corporation and its stock has certain limitations common to such corporations" the stock was not within the statutory definition (J.A. 47a). See also *id.* at 50a ("the stock which Ruefenacht received contains all the attributes mentioned by the *Forman* Court as indicating that the transaction did involve a security").

[10] A shareholder cannot "use or consume" corporate assets with impunity. A manager who appropriates corporate assets to personal use would violate a fiduciary duty to other stockholders as well as proscriptions against self-dealing. See generally 1 W. Fletcher, *Cyclopedia of the Law of Private Corporations* § 31, at 346 (rev. 1983); 12B W. Fletcher, *Cyclopedia of the Law of Private Corporations* §§ 5806, 5807, 5810-5812 (rev. 1984); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971) (quoting *Pepper* v. *Litton*, 308 U.S. 295, 307 (1939)). Treating corporate assets as personal property may also permit corporate creditors to "pierce the corporate veil" and hold the controlling shareholder liable for corporate tort or contract obligations. See generally 1 Fletcher, *supra*, at §§ 41.10-41.60.

whether it represents a small fraction or a controlling block of the outstanding shares—confers a proportional voice in corporate management. *Forman*, 421 U.S. at 851. One who acquires a greater percentage of stock will naturally acquire a more substantial voice, reflecting the greater portion of the corporate capital that his investment represents. The exercise of that voice should hardly disqualify him from antifraud protection. As the court below observed (Pet. App. 33a): "Many investors may elect to participate in the management of a business in order to enhance their return on investment * * *." See also SEC Landreth Brief at 15-19 (further explaining why *Forman* militates against petitioner's petition).

B. In urging an interpretation contrary to the statutory language and legislative history, petitioner, citing *Marine Bank* v. *Weaver*, *supra*, relies on the prefatory clause "unless the context otherwise requires," which precedes all of the Acts' definitions. As explained more fully in the SEC Landreth Brief at 19-21, *Weaver* concerned the interplay between two comprehensive regulatory schemes; it authorizes no case-by-case inquiry into the equities and supposed legislative purpose for each application of the federal securities laws. Moreover, petitioner, who relies on the "context clause" to argue that the antifraud provisions are not applicable in the case of an instrument within the plain terms of the statute, "has the burden of showing that the 'context otherwise *requires*.' " *Exchange National Bank* v. *Touche Ross & Co.*, 544 F.2d 1126, 1137-1138 (2d Cir. 1976) (emphasis in original). The context of the present case—which involves no alternative federal regulatory scheme, and in which respondent's interest comes within the fundamental congressional purpose of protecting pur-

chasers and sellers of securities—does not justify a departure from the statutory language.[11]

III. SIGNIFICANT POLICY CONSIDERATIONS ALSO COUNSEL REJECTION OF THE SALE OF BUSINESS DOCTRINE

The court of appeals aptly noted (Pet. App. 29a) that adopting the sale of business doctrine would render sellers and purchasers unable to predict when the securities laws applied, which in turn "raises the cost of economic transactions, inhibits the flow of capital, spawns litigation, and in general benefits neither the parties nor the courts." As discussed in SEC Landreth Br. at 21-27, that doctrine creates substantial uncertainty in the application of the law, arbitrary distinctions between participants in the same transactions, and unfair results. The problem of unpredictability which we there discuss is exacerbated in cases such as the present which involve the transfer of much less than 100% of a corporation's stock.[12]

---

[11] In a similar situation in *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353, 389-390 & n.88 (1982), this Court refused to exclude from the antifraud protection of Section 4b of the Commodity Exchange Act defrauded purchasers of commodities futures who engaged in speculation rather than hedging. Relying in part on the similarity between the language of that provision and that of Section 10(b) of the Securities Exchange Act, the Court stated: "[T]his Court has recognized an implied cause of action under the Securities and Exchange Commission's Rule 10b-5 on behalf of *all* securities traders." 456 U.S. at 389 n.88 (emphasis supplied).

[12] Petitioner takes the position (Br. 26) that conventional stock is not stock for purposes of the securities laws where the purchaser "obtains significant control" or "actively participates in the enterprise." If obtaining control is a dis-

In such cases the sale of business doctrine requires evidence on the threshold issue of whether the purchaser obtained control.[13]

---

qualification, institutional investors or speculators who purchase a block of stock sufficient to confer a measure of control would have no antifraud protection against unscrupulous sellers. At the least, they would face the prospect of a threshold inquiry into whether their purchase conferred control in light of a multitude of factors such as the number and dispersion of shareholders. See *Golden* v. *Garafalo*, 678 F.2d at 1146. See also Thompson, *The Shrinking Definition of a Security: Why Purchasing all of a Company's Stock is not a Federal Security Transaction*, 57 N.Y.U. L. Rev. 225, 258 (1982) (proposing at least seven factors that courts applying the "sale of business" doctrine should consider). If participation in the company is the test, the courts would necessarily become embroiled in such questions as "whether part-time managers are passive or active, what classification to accord controlling shareholders who intervene sporadically, and the status of new investors who assume ambiguous roles as employees or who intend initially to remain passive but are soon forced into management roles." *Golden* v. *Garafalo*, 678 F.2d at 1146. See SEC Landreth Br. at 21-23. At the conclusion of this burdensome and unnecessary exercise, only the threshold question of whether the stock is a security will have been resolved.

[13] Petitioner's argument (Br. 30) that rejection of the sale of business doctrine will open the "floodgates" and lead to federal jurisdiction over "an infinite number of garden-variety commercial transactions involving stock" is overstated and inaccurate. Since courts assumed until very recently that all transactions involving stock were "securities" transactions (see Carson, *Application of the Federal Securities Acts to the Sale of Closely Held Corporations by Stock Transfer*, 36 Me. L. Rev. 1, 3 & n.17 (1984)), rejection of the sale of business doctrine should result in little or no increase in the workload of the federal courts. But adoption of the doctrine will lead to additional hearings on the issue of control.

Petitioner's theory (Br. 23) that no instrument can qualify as a security unless it meets the test for an investment contract would create problems even beyond the sale of business context. The requirement under that test of profits from the entrepreneurial or managerial efforts of others has been a stumbling block in various lower court cases where the status of debt instruments paying fixed interest has been at issue. Some courts have expressed doubt that debt instruments such as long-term corporate bonds could meet the "profits" requirement of the investment contract test. See *Hunssinger* v. *Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984); *Briggs* v. *Sterner*, 529 F. Supp. 1155, 1168 (S.D. Iowa 1981); *Hamblett* v. *Board of Savings & Loan Associations*, 472 F. Supp. 158, 165 (N.D. Miss. 1979).

Finally, the sale of business doctrine fails to recognize significant legal distinctions between a sale of stock and a sale of assets. For example, "one who purchases the stock in a corporation—a separate legal entity—assumes ownership of a business with both assets and liabilities," while one who purchases assets may generally avoid assuming liabilities and debts (*Daily* v. *Morgan*, 701 F.2d at 504). The possibility of hidden liabilities and obligations that may accompany the purchase of intangibles such as stock calls for a higher degree of protection for the purchaser. As this Court has noted, the securities laws were enacted in the face of a growing recognition that the common law of fraud governing chattels and realty is "ill-suited" to the sale of securities. *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). Persons like respondent who bargain for the purchase or sale of one of the very instruments the securities laws were designed to cover should have the protections of those laws.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

REX E. LEE
Solicitor General

LOUIS F. CLAIBORNE
Deputy Solicitor General

CHRISTOPHER J. WRIGHT
Assistant to the Solicitor General

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

ROSALIND C. COHEN
Assistant General Counsel

STEPHEN M. DETORE
Attorney
Securities and Exchange Commission

JANUARY 1985

☆ U. S. GOVERNMENT PRINTING OFFICE: 1985 461531 10153